IN THE

Supreme Court of the United States

October Term, 1964

No. 472

ROBERT P. McCULLOCH,

Plaintiff and Appellant,

vs.

CALIFORNIA FRANCHISE TAX BOARD,

Defendant and Appellee.

JURISDICTIONAL STATEMENT.

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JURISDICTIONAL STATEMENT.

Appellant appeals from the judgment of the Supreme Court of the State of California entered on April 22, 1964, denying a rehearing (upon petition for rehearing timely filed) of its final judgment entered March 24, 1964, which in turn remanded a judgment of the Superior Court of the State of California, County of Los Angeles, entered August 13, 1961. Appellant submits this statement to show that the Supreme Court of the United States has jurisdiction of the appeal and that a substantial question is presented.

Opinion Below.

The opinion of the Supreme Court of the State of California is reported at 61 Adv. Cal. 171, 37 Adv. Cal. Rptr. 636, 390 P. 2d 412. The opinion of the California District Court of Appeal for the Second Di-

trict (which reversed the aforementioned judgment of the Superior Court) is reported only unofficially, at 30 Cal. Rptr. 922. Copies of the opinions referred to above and of the Findings of Fact, Conclusions of Law and Judgment of the Superior Court are attached hereto as Appendix A.

Jurisdiction.

This suit was an action brought by the plaintiff, appellant here, to recover payment of a deficiency assessment of California income taxes made under protest, in accordance with the provisions of California Revenue & Taxation Code §19082. The judgment of the Superior Court for the State of California in the County of Los Angeles was filed July 11, 1961, and entered August 13, 1961, denying appellant's claim for refund of California personal income tax.

Notices of appeal were duly filed in that Court on September 7, 1961, and after briefing and argument an opinion was rendered by the California District Court of Appeal, Second District, on May 24 1963, reversing and remanding the judgment of the trial court and allowing Appellant recovery of two-thirds of his claim on constitutional grounds.

Upon the timely filing and granting of petitions for hearing by both Appellant and Appellee California Franchise Tax Board, discretionary review was granted by the California Supreme Court on July 17, 1963. The opinion of the California Supreme Court was filed on March 24, 1964, and upon petition for rehearing, timely filed on April 8, 1964, an order was filed by that Court denying rehearing April 22, 1964. Notices of this appeal were filed in that Court July 17, 1964, and in the aforementioned Superior Court July 20, 1964.

The jurisdiction of the Supreme Court of the United States to review this decision on appeal is conferred by Title 28, United States Code, Sec. 1257(2). The following decisions sustain the jurisdiction of the Supreme Court to review the judgment:

Department of Banking v. Pink, 317 U. S. 264, 266 (1942) (time for filing tolled by petition for rehearing);

Raley v. Ohio, 360 U. S. 423, 436 (1959) (Federal claim adequately presented where expressly reviewed and disposed of by highest state court);

Accord, Saltonstall v. Saltonstall, 276 U. S. 260, 267 (1928) (trust case);

Cole v. Arkansas, 333 U. S. 196, 200 (1948) (surprise items in state Supreme court decision).

Questions Presented.

Wherever possible we state the questions in the language used in the opinion of the California Supreme Court (see 37 Cal. Rptr. 636, 643, 390 P. 2d 412, 419).

A. Under the Due Process clause of the Fourteenth Amendment—

1. May a contingent beneficiary's state of residence [California] properly tax a [foreign testamentary] *trust* on income which is payable in the future to the beneficiary, although it is actually retained by the trust [on the ground that] that state renders to the beneficiary [not the trust] that protection incident to his eventual enjoyment of such accumulated income [even though the

ing 1946-1950, the years when the trust received the income and when the state assertedly rendered the protection to the beneficiary, the beneficiary neither received the income nor had any right ever to receive it unless he survived to age 40 in a subsequent year and also satisfied other conditions at that later time?

2. Is "the tax imposed by California upon the beneficiary [in 1951] constitutionally supported by sufficient connection with, and protection afforded to, plaintiff as such beneficiary", on the ground that "California grants the beneficiary the interim protection of its laws" from 1946 through 1950—years when he is not actually receiving the taxed income and cannot receive it?

B. Under the Due Process and Equal Protection clauses of the Fourteenth Amendment, may California constitutionally tax the entire 1946-1950 accumulations of a foreign testamentary trust—

1. where the California statute (Revenue & Taxation Code §18103) provides that "the income taxable * * * shall be apportioned according to the number of fiduciaries resident in this state"? and . . .

2. where, in 1946-1950, only *one* of the three trustees was resident in California, the others (an individual and a corporation) being non-residents? and . . .

3. where the "custody, collection, accounting and distribution" of trust assets throughout the life of the trust were required by express provisions of the trust instrument to rest solely with the non-resident corporate trustee?

C. Under the Due Process and Equal Protection clauses of the Fourteenth Amendment, may California impose a "throwback" rule of income taxation on 1946-1950 accumulations of a foreign trust by judicial decision, even though a similar "throwback" rule was not applied to domestic California trusts until 1955?

Statutes Involved.

California Revenue & Taxation Code, Sections 17101, 18101, 18102, 18103, 18104, 18105 and 18106*, and Amendment XIV, Section 1, of the United States Constitution, are set forth in Appendix B.

Statement of the Case.

Stipulated Facts.—None of the facts of this case are in dispute; all were presented by admitted allegations or written stipulation in the trial court.

The subject of this litigation is income taxation of a 1951 distribution of principal, including income accumulated and added to principal in previous years, by a foreign testamentary trust. The trust was created under the will of plaintiff's grandfather, John I. Beggs, who was a non-resident of California when he died.

*The Section referred to above have been renumbered since 1955 as Sections 17071 (substantially similar), 17731 (subsection (b) added), 17742, 17743, 17744, and 17745. Section 18105 is in part incorporated in Section 17731(b).

While the subject income was being accumulated (1946-1950) plaintiff was one of three trustees of the trust. He was not one of the trustees originally provided for in the will. During all times relevant in this case, plaintiff was the only trustee who was a resident of California; the other trustees were John I. B. McCulloch, a resident of Missouri, and the St. Louis Union Trust Company, a Missouri corporation not authorized to transact business in California, and not in fact transacting business in California.

The custody and control of all assets of the trust were always outside of California, in accordance with the express terms of the trust, which provided:

> "* * * custody, collection, accounting and distribution of the assets and income of my estate shall reside *with the Trust Company* Executor and or *Trustee* for and so long as there shall be a Trust Company serving in that behalf." (Emphasis supplied.)

The assets of the trust during the years 1946 to 1951 consisted of stocks, bonds and certain real property. Some of the bonds were municipal bonds issued by various districts, including the State of California; some of the corporate stocks were issued by corporations which were incorporated and did business in California and others by corporations outside the State of California; the real property held by the trust was not located in California, and the physical evidences of the stocks and bonds owned by the trust were kept in Missouri.

The trust provided for the creation of separate trusts for each of the testator's grandchildren (one of whom

was appellant), for payment out of income and invasion of principal, in the trustees' discretion for the education, training and recreation of the grandchildren up to the age of twenty-five years. It further provided for payments to each beneficiary of $50,000 if he reached twenty-five, $100,000 if he reached thirty, $350,000 if he reached thirty-five, and the following at age forty:

> "* * * As my grandchildren respectively *become forty years of age*, the trusts as to them shall be terminated, and the Trustees shall, *subject to the discretionary powers hereinafter conferred upon them*, convey, transfer, deliver and pay to them the principal and any accumulated income of the apportionments then held in trust for said grandchildren, respectively, except that for the time being the Trustee shall retain such part of the share of such grandchild as in their sole judgment is proper and proportionate to insure the payment of the annuities and other obligations herein stipulated to be paid." (Emphasis supplied.)

However, this provision was restricted by the following provision:

> "15. In case any beneficiary of any of the trusts hereby created for my grandchildren or my heirs-at-law, at the time when any payment becomes due to him, her or them pursuant to the foregoing provisions, are not, *in the judgment of the Trustees, of such habits and of such mental or business capacity, as to be able to prudently manage and properly care for the same*, then *the Trustees may, and should, withhold part, or all, of such sum, and may* continue to hold, manage, invest and

reinvest the same, and pay to, expend or have expended for such beneficiary, the income, or such part thereof, or withhold principal, as may be reasonable in the discretion of the Trustees, for the maintenance and pleasure of such beneficiary, or of their family or of those dependent upon them, or the Trustees, in their discretion, may from time to time pay any beneficiary, such amounts with which they think such beneficiary may be prudently entrusted, the remainder to be held for investment and reinvestment, as aforesaid, until such time as the Trustees may deem it prudent and proper to make additional or full payment." (Emphasis supplied.)

The trust likewise contained a spendthrift clause and provided that the interest of any grandchild who died before the trust had terminated as to him was to pass to his heirs-at-law who were related by blood to the settlor. The trust provided for the continuing support of the widow of any deceased male grandchild.

Proceedings Below.—Appellee, California Franchise Tax Board, assessed an income tax deficiency against Appellant, charging him with additional taxable income in 1951 equal to the sum of all 1946-1951 accumulations distributions. These were received by Appellant in 1951 as part of a lump sum distribution from the foreign testamentary trust. Appellant paid the deficiency and sued for refund in the appropriate state trial court, the Superior Court of the State of California for the County of Los Angeles.

The suit for refund was denied in the trial court and judgment entered for Appellee Board. An appeal was

taken to the California District Court of Appeal (Second District), and that court (one justice dissenting) expressly upheld Appellant's claims of unconstitutionality in part but imposed taxation on one-third of the accumulations distributed in 1951 on the ground that during 1946-1950 one of the three trustees was a California resident—denying in this respect Appellant's claims of unconstitutionality of the statute as applied.

Upon petition for hearing filed by both parties in the California Supreme Court, that court granted discretionary review and filed an opinion, denying all Appellant's claims of unconstitutionality but assessing a tax against the beneficiary computed as if due from the *trust* on income received by the trust during each year of accumulation, refusing to tax the entire accumulation distribution as if received by Appellant or by the trust in a lump-sum in one year.

A petition for rehearing was timely filed by Appellant, urging (*inter alia*) that certain new constitutional questions had been raised for the first time in the California Supreme Court's opinion; rehearing was denied without opinion on April 22, 1964.

How the Federal question was presented.—The Federal questions here sought to be reviewed were expressly passed upon by the California Supreme Court in its opinion. That court held in substance that the beneficiary's state of residence may constitutionally impose a tax on accumulations of a foreign *trust* because of the residence of the *beneficiary*, even though income is payable only in the future, if at all, to that beneficiary, and that such a tax is supported by a sufficient connection between the state and the beneficiary.

See 61 Adv. Cal. 171, 179, 181, 37 Cal. Rptr. Adv. 636, 641-642, 643, 390 P. 2d 412, 417-418, 419:

"This statutory system of taxing trusts, as we shall explain, encounters no constitutional prohibitions. Plaintiff contends that we must condemn the tax as failing in due process because California could not have taxed him as a beneficiary of the income during the years of its accumulation; that the evidence of ownership of the trust assets and the accumulated income reposed in Missouri from 1946 to 1951 and during that period plaintiff did not actually receive, own, or control the income to connect it with California. * * *"

"We find no reason in constitutional principles or in practical application of such principles why the tax founded upon the residence of the beneficiary should not be sustained. * * *"

"* * * In similar fashion, the beneficiary's state of residence may properly tax the *trust* on income which is payable in the future to the beneficiary, although it is actually retained by the trust, since that state renders to the beneficiary that protection incident to his eventual enjoyment of such accumulated income."

"The tax imposed by California upon the beneficiary is constitutionally supported by a sufficient connection with, and protection afforded to, plaintiff as such beneficiary. * * *"

These constitutional questions were placed in issue by both Appellant and Appellee Board in their respective petitions for hearing, and by Appellant's Petition for Rehearing before the California Supreme Court.

Respondent Board's Petition for Hearing before the State Supreme Court stated in part at page 4:

> "* * * the majority of the District Court of Appeal concluded that though accumulated income is constitutionally taxable to a beneficiary upon receipt in 1951, it is taxable under our statute only if it were constitutionally taxable to the trust *during accumulation from 1946-1950.* The majority then concluded that the income is not taxable during accumulation, despite the express provisions of sections 18102 and 18104 because that statute, it states, is unconstitutional when taxation is 'predicated solely on residency of a contingent beneficiary.'"

Appellant's Petition for Rehearing stated in part at page 11:

> "In other words, under California law accumulations were not taxed upon distribution until 1955; but under this decision such accumulations will be taxed as income, at least as to one-third, upon a distribution made in 1951. There is no logical reason thus to discriminate against a foreign trust and thus to tax it in a way that domestic trusts are not taxed. Such taxation violates the Fourteenth Amendment to the United States Constitution."

See, also, Appellant Robert P. McCulloch's Petition for Rehearing, Topical Index, stating:

"Page

A. New constitutional questions raised for the first time by this court's opinion 1

I.

Without prior warning this decision, by judicial interpretation, applies 'throwback' principles to taxable years 5-9 years prior to enactment of 'throwback' legislation, in violation of due process and equal protection clauses of the Federal Con ution.. 1

II.

This de sion, without prior warning, imposes a tax upon the trust by reason of the residence of the contingent beneficiary, in violation of the express statutory scheme of taxation ..... 4"

On appeal from the trial courts to the California District Court of Appeal, the constitutional questions sought to be raised here were also raised, this time in the briefs of the Appellant, who was likewise appellant there. See the following, quoted from the Topical Index of Appellant's Opening Brief, California Second District Civil No. 26134:.

"Page

B. The statutes, if applicable, are unconstitutional because:

1. If taxpayer was such a 'beneficiary', California's attempt to tax trust accumulations to the distributee in the year of distribution, solely upon the ground that the distributee was a resident of California, is a violation of the Fourteenth Amendment to the United States Constitution 28

2. Taxation of the income of a trust by the State of California based upon the fact that one of three trustees is a resident of California is a violation of the Fourteenth Amendment of the United States Constitution, and if Section 18102 of the Revenue and Taxation Code (1953) is interpreted to permit taxation on this ground alone, the section is unconstitutional and void ..... 39"

The District Court of Appeal decided the constitutional questions raised by Appellant in the following language (see 30 Cal. Rptr. 922, 925-926):

"* * * Under the circumstances of the present case, taxation by the State of California of the trust with respect to income received and accumulated in any one of the years 1946-1950 could not be predicated solely on the residence of the plaintiff in California during such years because the necessary nexus required by the concept of due process did not then exist. (See *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 343-345 [74 S. Ct. 535, 98 L. Ed. 744, 747-748].) The remaining question, therefore, is whether, in view of the fact that one of the trustees was a California resident, the State of California had jurisdiction to impose an income tax on one-third of the income which was accumulated rather than currently distributed to the beneficiary. (See Rev. & Tax. Code, former §18103, supra.)"

"Guidance in the solution of the problem of jurisdiction to tax is found in the reasoning of the Supreme Court in *Greenough v. Tax Assessors*,

331 U.S. 486 [67 S. Ct. 1400, 91 L. Ed. 1621, 172 A.L.R. 329], although the court was there concerned with a property tax. * * *"

"In the light of the reasoning of the *Greenough* case, this court is not free to interfere with the clear legislative intent to impose upon a trustee resident in California the duty of paying income tax upon a proportionate amount of the income received by the trust."

The Questions Raised Are Substantial.

Questions novel.—The case is one of first impression, as appears to be conceded both by the Appellee Board, the California District Court of Appeal, and the California Supreme Court. All refer in brief or opinion to the same quotation from Sabine, *Constitutional and Statutory Limits on the Power to Tax*, 12 Hastings L. J. 23, 39 (1960):

"The constitutional validity of a tax by the state of residence of the *trustee* on accumulated net income, appears to have acceptance by the United States Supreme Court. The Court, however, has not yet had occasion to decide the validity of a tax with respect to accumulated income where the trustee is a nonresident and the tax is founded on residence of the beneficiary."

Furthermore, there is no case (and none is cited by the California Supreme Court) which has ever before imposed income tax on a *trust* based upon the residence of a *beneficiary* during the years when, as to the income sought to be taxed, the beneficiary did not in fact *actually receive* the income. Each of the cases cited by the California Supreme Court were cases where,

in fact, the income taxed was *actually received* by the entity whose residence was the basis for taxation (either the trust or the beneficiary). Yet these were the cases relied upon to support the proposition that "*the beneficiary's* state of residence may properly tax the *trust* on income which is payable [if at all, only] in the future to the beneficiary . . . ." App. A, p. 11, 61 Adv. Cal. 171, 181, 390 P. 2d 412, 419, 37 Adv. Cal. Rptr. 636, 643. (Emphasis supplied.)

New York ex rel. Cohn v. Graves, 300 U. S. 308, 312-313 (1937), ("*receipt of income*" by resident taxable; protection of "enjoyment . . . when *received*");

Guaranty Trust Co. v. Virginia, 305 U. S. 19, 23 (1938), ("the thing taxed was *receipt* of income within Virginia");

Maguire v. Trefry, 253 U. S. 12, 14 (1920), (income *actually received* held taxable; tax founded upon "protection afforded to the *recipient* of the income");

Lawrence v. Tax Commission, 286 U. S. 276, 281 (1932), ("protection afforded the *recipient* of the income");

Stewart v. Pennsylvania, 312 U. S. 649 (1941), *aff'g.* 338 Pa. 9, 12 A. 2d 444 (1940) (property tax on vested interest of life beneficiary *actually* receiving income). [Emphasis everywhere supplied.]

While novelty alone is no guarantee that this case is important, we suggest that the issues here involved are of substantial importance because of the general growth in the use of trusts, the increase in the use of

trusts for tax and other reasons, the increasing interstate mobility of population;[1] all these factors combine to magnify the importance today of the questions raised by this case and undecided thus far.

Nexus—The states do not have a license to range at large, taxing whatever falls into their grasp. Some relationship must exist to justify the tax, and the relationship must exist "between such a tax and transactions within a state for which the tax is an exaction."

Northwest States Portland Cement Co. v. Minnesota, 358 U. S. 450, 464 (1959);

Wisconsin v. J. C. Penney Co., 311 U. S. 435, 445 (1940).

Where some relationship exists, but it is not connected closely enough with the assertedly taxable transactions, then the tax violates the Due Process Clause.

Miller Bros. v. Maryland, 347 U. S. 340 (1954).

The case before us holds that California had power to impose an income tax on accumulations received by the *trust* from 1946 through 1950 because, during those years, it was 1) keeping some of the then contingent remaindermen alive until one or another could survive to the requisite age and satisfy the other conditions necessary to collect the accumulations, and because it was 2) serving as the repository of law which would enforce spendthrift clauses and perhaps allow the remaindermen the possibility of seeking re-

[1] See Statistics of Income, 1958—Fiduciary, Gift & Estate Tax Returns (U. S. Int. Rev. Serv., 1961) pp. 4 and 30, showing that over 406,000 trust returns were filed in 1959 for taxable years beginning in 1958, of which 188,805 were taxable, compared with 29,577 taxable returns in 1949.

dress for trust violations in its courts. (App. A. p. 12) 61 Adv. Cal. 171, 181, 398 P. 2d 412, 419, 37 Adv. Cal. Rptr. 636, 643.

No case in this Court has so attenuated the concept of *nexus*. No case has ever held that personal welfare or legal protection accorded a *beneficiary* is a sufficient basis upon which to tax accumulations, not then received by the beneficiary, to a *trust*. *Cf. Hanson v. Denckla*, 357 U. S. 235, 253 (1958).

All of the cases dealing with the constitutional question of jurisdiction to tax have required something more than mere personal welfare or legal protection—have required some "fiscal relation" between the state's taxing power and the protection accorded by the state. See *Wisconsin v. J. C. Penney Co.*, quoted page 16, *supra*, and see each of the cases cited by the California Supreme Court, referred to at pages 14 to 15 *supra*. Each of the last cases referred to found such a fiscal relation in the fact that the person taxed either received or held custody over the property or income taxed.

Taxpayer, Appellant here, did neither. As beneficiary, he could not touch the income here in question—let alone receive or enjoy it—until after the taxable years 1946-1950, the years when tax liability is sought to be imposed on the trust by this decision. And as trustee, he was only one of three such and expressly prohibited from maintaining "custody, collection, accounting and distribution" of the trust estate; custody resided with the non-resident corporate trustee.

The *nexus* theory of acquiring jurisdiction is not limited to tax cases. It finds its root in the same principles as have been enunciated in those cases which go

erally discuss the question of jurisdiction in other situations.

See *Note*, "Validity, Under Federal Constitution, of State Tax on * * * Income of Foreign Corporation", 67 A. L. R. 2d 1322, 1330 (1959):

"The 'contact' or 'nexus' theory was established by International Shoe Co. v. Washington, 326 U.S. 310. * * * The 'nexus' or 'contact' theory has been applied to test a state's power to tax a foreign corporation." [Footnote cites *Miller Bros. Co. v. Maryland*, 347 U. S. 340 (1954).]

Atkinson v. Superior Court, 49 Cal. 2d 338, 345 (1957):

"It is significant that with respect to jurisdiction to tax intangibles (*Curry v. McCanless*, 307 U.S. 357, 373-374 (59 S.Ct. 900, 83 L.Ed. 1339, 123 A.L.R. 162)), jurisdiction over foreign corporations (*International Shoe Co. v. Washington*, 326 U.S. 310, 316 (66 S.Ct. 154, 90 L.Ed. 95, 161 A.L.R. 1057); *Perkins v. Benguet Min. Co.*, 342 U.S. 437, 445 (72 S.Ct. 413, 96 L.Ed. 485)), and jurisdiction to adjudicate trust obligations (*Mullane v. Central Hanover Bank & Trust Co.*, 339 U.S. 306, 311-313 (70 S.Ct. 652, 94 L.Ed. 865)), emphasis is no longer placed on actual or physical presence but on the bearing that local contacts have to the question of over-all fair play and substantial justice. A similar change in emphasis has been taking place with respect to personal jurisdiction over individuals. (Citations.)" 49 Cal. 2d at 345.

None of these cases, or those cited in the above quotations, permits the extension of mere police or fire pro-

tection, or of unlikely putative legal benefits (which in this case were not invoked and could not have been) to justify assumption of jurisdiction, either to adjudicate controversies or to impose tax.

Cf. Hanson v. Denckla, 357 U. S. 235, 253-254 (1959) (*non*-resident trustee):

> "* * * The application of that rule will vary with the quality and nature of the defendant's activity, but it is essential in each case that there be some act by which the defendant purposefully avails itself of the privilege of conducting activities within the forum State, thus invoking the benefits and protections of its laws. *International Shoe Co. v. Washington*, 326 U.S. 310, 319. The settlor's execution in Florida of her power of appointment cannot remedy the absence of such an act in this case."

The teaching of the foregoing cases is that there must be a "minimum connection", which in each of those cases was greater than the minimum connection provided here. The California Supreme Court, while conceding that such a "minimum connection" must exist between the state and the subject of the tax (61 Adv. Cal. 171, 182, 390 P. 2d 412, 420, 37 Cal. Rptr. 636, 644) apparently feels that such a constitutional requirement was satisfied and cites in its support *Miller Bros. v. Maryland*, 347 U. S. 340 (1954). Yet that case held that there did *not* exist sufficient *nexus* to support taxation. In substance, the current case reaches in degree (though not in kind) the same lack of *nexus* illustrated by *Miller*. The *Miller* case in fact held that the protection accorded the Maryland inhabitants who purchased the taxpayer's wares in Delaware was *not*

sufficient to support a Maryland use tax levied on the foreign taxpayer, not on the inhabitants. We suggest that any protection accorded a remainderman—to keep him alive until he can collect accumulations—is not sufficient to support a tax on a foreign trust.

Taxation of all income paid on residence of one-third of trustees.—California Revenue & Taxation Code former Section 18103 (now Section 17743) requires apportionment of income taxable under the statute in accordance with the number of fiduciaries resident in California. Despite this explicit direction, the California Supreme Court *held* that appellant's "secondary role as a trustee reinforces the independent basis of taxing plaintiff as beneficiary." 61 Adv. Cal. 171, 184; 37 Adv. Cal. Rptr. 630, 645, 390 P. 2d 412, 421.

Even *Greenough v. Tax Assessors*, 331 U. S. 486 (1947), which based a property tax (a tax on legal ownership) on the residence of one of two trustees, only taxed a proportionate part of the property to the resident trustee. That case implicitly recognized (as does the California statute) that all of the trustees must reside in California in order to permit imposition of an entire tax. See 331 U. S. 486, 498. The instant case is novel and, we suggest, erroneous, in resting the imposition of the entire tax upon the residence of only one of three trustees.

Furthermore, in the present case the residence of but one of three trustees provides even less of a support for taxation because of the provisions of the trust, which specifically conferred all administrative control, possession, "custody, collection, accounting and distribution of the assets and income" of the trust on the non-

resident corporate fiduciary. In substance, the single trustee resident in California had no control and no powers which he could exercise in this State independently of the other trustees. He had therefore no protectible interest which may provide a constitutional basis for imposing taxation upon him as trustee.

C. The California Supreme Court was unwilling to tax the beneficiary in a fashion "which treated the whole accumulation as income in the year of its distribution" (See 61 A. C. 171, 178 37 Adv. Cal. Rptr. 630, 641, 390 P. 2d 412, 417), but instead asserted a liability against appellant for taxes as if the trust had been liable for taxation on the income it accumulated for the years 1946 through 1950, spreading the tax on the 1951 accumulation distribution back over the prior years of its accumulation.

This determination flies in the face of the fact that the California legislature did not enact such an income tax law with respect to trusts, foreign or domestic, until 1955. Thus, the California Supreme Court seeks to impose a tax in 1951 which the legislature itself gave notice it did not intend to impose until 1955, since its "throwback" statute (enacted to conform with that of the 1954 Federal Internal Revenue Code) was expressly *not* made effective until the taxable years beginning after December 31, 1954, and was presumptively and actually a change in the pre-existing tax law.

This new construction by the State Supreme Court of a statute affecting 1951 taxation deprives appellant of property without due process of law, if at variance with prior construction previously employed.

Brinkerhoff-Faris Trust & Savings Co. v. Hill
281 U. S. 673, 678-679 (1930);

Cole v. Arkansas, 333 U. S. 196, 201 (1948);
International Steel Co. v. Surety Co., 297 U. S. 657, 665 (1936).

The California Supreme Court's enunciation of its judicially created "throwback" rule for 1951 (though none was passed by the legislature until 1955) does violence to the statutory scheme of taxation upon which taxpayer is entitled to rely as of 1951.

Such a construction likewise violates the equal protection laws of the Fourteenth Amendment, since it subjects an out-of-state trust to a "throwback" rule for 1951 without subjecting local trusts thereto, and without any reason for differentiating thus between foreign and domestic trusts.

Cf. Spreckels v. Commissioner, 101 F. 2d 721, 722 (9th Cir. 1939) (Federal rule during 1951—no tax on accumulations distributed to beneficiary);
Accord, 2 Rabkin & Johnson, *Federal Income, Estate & Gift Taxation*, Section 54.09(3).

These cases enunciate the Federal rule, followed in California in 1951, as to domestic trusts.

Cf. Malmgren v. McColgan, 20 Cal. 2d 424, 427, 126 P. 2d 616, 618 (1942) (holding that in case of accumulations of estate income one of the requirements for taxability to the legatee under California's tax laws is that the accumulations "must be paid or credited to the legatees * * * during that taxable year [the year of actual receipt by the state]").

To apply a different rule to a foreign trust without any suggestion of a reason for such discrimination, is a denial of equal protection.

Respectfully submitted,

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APPENDIX A.

[L.A. No. 26678. In Bank. March 24, 1964.]

Robert P. McCulloch, Plaintiff and Appellant, v. Franchise Tax Board, Defendant and Respondent.

[On hearing after decision by the District Court of Appeal, Second Appellate District, Division Three, Civ. No. 26134 (216 A.C.A. 631, 30 Cal.Rptr. 922) reversing with directions judgment of the superior court. Judgment reversed with directions.]

Appeal from a judgment of the Superior Court of Los Angeles County. Jesse J. Frampton, Judge. Reversed with directions.

Action to recover state income tax paid under protest on accumulated income distributed by an out-of-state discretionary trust. Judgment for defendant reversed with directions.

Brady & Nossaman, Walter L. Nossaman and Joseph L. Wyatt, Jr., for Plaintiff and Appellant.

Stanley Mosk, Attorney General, Dan Kaufmann, Assistant Attorney General, Jay L. Shavelson and Harry W. Low, Deputy Attorneys General, for Defendant and Respondent.

Tobriner, J.—This case involves the state income tax consequences of a terminal distribution of the income accumulated by a discretionary trust during the period of the beneficiary's residence in California. Plaintiff, the beneficiary of the trust and one of the trust's three trustees, protests California's assessment of a tax deficiency upon the accumulated income distributed to him. We find that plaintiff's California residence established sufficient contact of the trust with this state

to subject it to California income tax. Since the trust failed to pay this state's tax upon its annual income, California can constitutionally tax the beneficiary at the time he receives the accumulated income; he is liable for the tax owed by the trust upon such annual income.

Plaintiff, a resident of Los Angeles, became entitled in 1951 to a terminal distribution of the assets of a testamentary trust created for his benefit. The assets which he accordingly received included income which the trust accumulated during the five years from 1946 through 1950 while he thus resided in California. Because he did not include with his income from all other sources the five-year trust accumulation, the Franchise Tax Board assessed an income tax deficiency against plaintiff for the year 1951. We pass here only upon his income tax liability for that portion of the distribution.[1]

Plaintiff paid the deficiency assessment under protest; when the Franchise Tax Board denied his claim for refund, plaintiff sought recovery of the payment in the superior court (Rev. & Tax. Code, § 19082), contending that the accumulated trust income of prior years could not properly be subjected to California income tax in the year when plaintiff received it. The trial court denied plaintiff's claim for refund.

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[1]Plaintiff is a cash basis taxpayer whose tax year is coextensive with the calendar year. He declared as income during 1951 only that portion of the distribution which represented income received by the trust during that year; the parties concede that plaintiff incurred current tax liability for the trust's 1951 income, but the Franchise Tax Board challenges plaintiff's omission from his 1951 tax return of the accumulated income for the five prior years.

We find that the Franchise Tax Board properly imposed upon plaintiff liability for income taxes upon the accumulated income distributed by the trust, but that the board in computing the tax should not have included in plaintiff's regular income for 1951 the lump sum of such accumulation. Plaintiff, as the distributee of trust assets, owes California income taxes which the *trust*, as a separate taxable entity, incurred upon its income during *each of the five prior years as it was earned*. As we shall explain, the beneficiary's residence in California during this period subjected the trust to liability for state income taxes on its undistributed income.

As the stipulated facts show, plaintiff's grandfather, who was not a California resident at the time of his death, named plaintiff as beneficiary of a testamentary trust. Plaintiff shared the administration of this trust with his brother, a Missouri resident, and a third trustee, the St. Louis Union Trust Company of Missouri.

The grandfather created testamentary trusts for the benefit of each of his grandchildren. He authorized the trustees to distribute annually to those beneficiaries over the age of 25 "such part of the net income of their respective portions held in trust as may be necessary or advisable to assist them in business, professionally or otherwise." Thereafter, "the net income of the trust estate, or of the *respective trusts*, not disbursed from year to year shall be *added to the principal* and thereafter invested and disbursed as herein authorized." (Italics added.)

As each grandchild successively reached the ages of 25, 30, and 35 years, he became entitled to distribution of specified amounts of trust assets; as each grand-

child attained the age of 40, he was to receive the terminal distribution of his portion of the principal together with the income accumulated for him. Any scheduled distribution or termination of the trust might be postponed if the trustees concluded that the respective beneficiary could not capably manage the funds.

In addition, the trust prohibited anticipation of payments by a beneficiary or the alienation or disposition of his or her interest in the trust. The interest of any grandchild who dies before the trust had terminated as to him was to pass to his heirs-at-law who were related by blood to the settlor; the trust provided for the continuing support of the widow of any deceased male grandchild.

The trust paid state income taxes to Missouri upon its income for the years 1946 to 1950, inclusive; it paid no income tax to California during that period. Plaintiff, as beneficiary, did not include in his computations of personal income tax for those years any of the undistributed income earned by the trust. The Revenue and Taxation Code imposes upon the trust the obligation to pay state taxes applicable to discretionary annual income accumulations retained by the trust. (See Sabine, *Constitutional and Statutory Limits on the Power to Tax* (1960) 12 Hastings L.J. 23, 38, 39.) If this trust failed to pay California income tax validly imposed upon its earnings, plaintiff became liable for payment at the time of distribution.

We consider the problem, first, from the standpoint of statutory construction, and, second, from the constitutional aspects.

California has evolved a comprehensive system for the taxation of trust income patterned upon the fed-

eral tax structure, which treats the trust as a separate economic entity.[2] The statute requires the trustee to pay, on behalf of the trust, taxes due on the taxable income of the corpus; such income includes income which the trust accumulates or holds for future distribution, whether the interest of the beneficiary is absolute, contingent, or vested subject to divestment.[3] Former section 18106[4] of the Revenue and Taxation Code, which applies to this case, provides: "If, *for any reason*, the taxes imposed on income of a trust which is *taxable to the trust* because the fiduciary or beneficiary is a resident of this State are *not paid when due and remain unpaid* when *such income* is distributable to the beneficiaries . . . *such income* shall be taxable

[2] "[W]e do not forget that the trust is an abstraction, and that the economic pinch is felt by men of flesh and blood. Even so, the law has seen fit to deal with this abstraction for income tax purposes as a separate existence, making its own return under the hand of the fiduciary and claiming and receiving its own appropriate deductions." (*Anderson v. Wilson* 1933) 289 U.S. 20, 27 [53 S.Ct. 417, 77 L.Ed. 1004, 1010].)

[3] Section 17731 of the Revenue and Taxation Code today incorporates the substance of former Revenue and Taxation Code sections 18101 and 18105. Section 18101 of the Revenue and Taxation Code at the date of distribution stated in part: "The taxes imposed by this part upon individuals apply to the income of estates or of any kind of property held in trust . . . including: (a) Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests, and income accumulated or held for future distribution under the terms of the will or trust. . . . (d) Income which, in the discretion of the fiduciary, may be either distributed to the beneficiaries or accumulated."

Section 18105 of the Revenue and Taxation Code provided in part: "Taxes on income of an estate or trust which is taxable to the estate or trust . . . shall be paid by the fiduciary."

[4] Revenue and Taxation Code section 17745 now contains this identical language. Although in determining plaintiff's tax obligation we look to the statutory scheme then effective, we note that these statutes have not been altered in substance; only the numbering is changed.

to the beneficiaries when distributable to them. . . . ." (Italics added.)

This section forms one of the foundation stones in the structure of rules applying California income taxes to trust income. As to a trust which has contacts that are partly local and partly foreign, the sections provide that the entire undistributed income becomes taxable by California "if the *fiduciary or beneficiary* is a resident" of this state. (Rev. & Tax. Code, § 18102, now incorporated in § 17742. (Italics added.)[3]

California taxes the trust upon that portion of the annual income which the trust holds for eventual distribution to the California resident beneficiary. If the trustee fails to pay the tax for the trust *annually as it earns the income*, the California resident beneficiary becomes liable for such tax when the previously earned income is distributed to him.

The statute refers to the *income* of a trust; it imposes upon the beneficiary the tax liability which attaches to "such income." The Legislature manifestly relied upon the traditional concept of "income" in selecting this word. Webster's New International Dictionary, 2d edition, defines income as "That gain or recurrent benefit . . . . which proceeds from labor, business or property . . . .": the definition obviously expresses the common understanding of the word's

[3]If the basis for taxing trust income is the residence here of the trustee, and other trustees reside elsewhere, the tax is apportioned according to the interest represented by the resident trustee. (Rev. & Tax. Code, § 18103, now found in § 17743.) If the basis for taxing trust income is the residence here of a beneficiary, and other beneficiaries reside elsewhere, the tax is apportioned according to the interest represented by the resident beneficiary. (Rev. & Tax. Code, § 18104, now found in § 17744.)

meaning. "Principal" constitutes the capital sum or corpus. Under standard principles of trust accounting, and, indeed, pursuant to the specific directions of the instant trust instrument, income accumulations were added to principal. Once the income has been entombed as principal within the trust, we cannot later resurrect it as income.

Neither the arguments of the Franchise Tax Board nor plaintiff refute this proposition.

We cannot accept the position of the Franchise Tax Board that the beneficiary becomes taxable at the time of distribution upon the *total* amount accumulated by the trust during the five prior years as though it were part of the income of the beneficiary in the year he received it. Thus the Franchise Tax Board contends that section 18100 imposes upon the beneficiary a new and different tax, measured by the amount of the trust distribution which represented income accumulated while the beneficiary resided in California, yet payable only if the trust failed to pay California income taxes.

The theory of the Franchise Tax Board fails for two reasons. First, as we have indicated, the board's interpretation of section 18100 distorts the distinction between income and principal; the statute indicates only that if trust income taxes remain unpaid, these taxes are to be met by the beneficiary when the assets are distributed to him. Second, the position which the Franchise Tax Board adopts would construe section 18100 as a penalty upon the beneficiary. If the trust paid its California income taxes, the beneficiary would not be required to pay any tax on the accumulation when he received it; if the trust failed to pay such California income taxes, the beneficiary, who is with-

out fault, would be penalized by the exaction of a tax which treated the whole accumulation as income in the year of its distribution. We find no basis for holding that the Legislature intended so harsh a result.

Nor can we accept plaintiff's position that California cannot properly subject the beneficiary to any tax liability whatsoever on the income accumulation. Plaintiff contends that until he received the final distribution of trust assets at age 40, he held only a defeasible interest which could not support the imposition of the tax. Yet, as the condition of plaintiff's survival without mental incapacity was annually fulfilled, he continued to enjoy his right to the advantages flowing from additional accumulations of income in the trust. Plaintiff's survival to age 40 is material only to his *personal* liability for payment of the tax liability of the trust as a transferee of the assets under the terms of section 18106.

The further point urged by plaintiff, that accumulated income had become principal when plaintiff received the distribution, does not obliterate the liability imposed by section 18106. The tax rests upon earnings which were clearly income as these accrued each year to the fictionalized legal entity, the trust. Plaintiff bears statutory liability as a transferee for taxes "due . . . and unpaid" by the trust upon such income.

This statutory system of taxing trusts, as we shall explain, encounters no constitutional prohibitions. Plaintiff contends that we must condemn the tax as failing in due process because California could not have taxed him as a beneficiary of the income during the years of its accumulation; that the evidence of ownership of the trust assets and the accumulated income reposed in

Missouri from 1940 to 1951 and during that period plaintiff did not actually receive, own, or control the income to connect it with California. To narrow the issue further, in the words of Sabine, "The constitutional validity of a tax by the state of residence of the trustee on accumulated net income appears to have acceptance by the United States Supreme Court. The Court, however, has not yet had occasion to decide the validity of a tax with respect to accumulated income where the trustee is a nonresident and the tax is founded on residence of the beneficiary." (Sabine, *Constitutional and Statutory Limits on the Power to Tax* (1960) 12 Hasting L.J. 23, 39; fns. omitted.)

We find no reason in constitutional principles or in practical application of such principles why the tax founded upon the residence of the beneficiary should not be sustained. We shall point out that just as the protection and benefits afforded by the state of the residence of the trustee serve as the basis for the constitutionality of the tax as to him, so do those factors serve as the basis for the constitutionality of the tax as to the beneficiary. Moreover, the possibility of double taxation does not defeat the imposition of the tax. (*State Tax Com. v. Aldrich* (1941), 316 U.S. 174 [62 S.Ct. 1008, 86 L.Ed. 1358, 139 A.L.R. 1436]; *Curry v. McCanless* (1939) 307 U.S. 357 [59 S.Ct. 900, 83 L.Ed. 1339, 123 A.L.R. 162]; *Graves v. Elliott* (1939) 307 U.S. 383 [59 S.Ct. 913, 83 L.Ed. 1356]; *Guaranty Trust Co. v. Virginia* (1938) 305 U.S. 19 [59 S.Ct. 1, 83 L.Ed. 16].)

The decisions of the United States Supreme Court clearly recognize that the residency of a trustee constitutes a valid basis for a local property tax upon trust

corpus apportioned to the trustee's interest (*Greenough v. Tax Assessors* (1947) 331 U.S. 486 [67 S.Ct. 1400, 91 L.Ed. 1621, 172 A.L.R. 329])[6]; in like manner property taxes apportioned to the value of the equitable interest may be imposed by the state of the beneficiary's residence. (*Stewart v. Pennsylvania* (1941) 312 U.S. 649 [61 S.Ct. 445, 85 L.Ed. 110], affirming 338 Pa. 9 [12 A.2d 444]; *Safe Deposit & Trust Co. v. Virginia* (1929) 280 U.S. 83 [50 S.Ct. 59, 74 L.Ed. 180, 67 A.L.R. 386]; *Commonwealth* ex rel. *Martin v. Sutcliffe* (1940) 283 Ky. 274 [140 S.W.2d 1028]; *Rowe v. Braden* (1933) 126 Ohio St. 533 [186 N.E. 392]; *Bingham's Admr. v. Commonwealth* (1923) 199 Ky. 402 [251 S.W. 936].)[7] The laws of the state of

[6]The *Greenough* case held valid an apportioned personal property tax of the City of Newport, Rhode Island. Since the trust was administered by two trustees and one trustee resided in the city and state, the city levied its tax upon one-half the value of capital stock held in trust. The court determined that, although the beneficiary and the second trustee resided in a different state and the trust was there administered, the benefit and protection afforded the single resident trustee supported the tax. In reaching this decision, the court said, "The trustee of today moves freely from state to state. The settlor's residence may be one state, the seat of a trust another state and the trustee or trustees may live in still another jurisdiction or may constantly change their residence. The official life of a trustee is, of course, different from his personal. A trust, this Court has said, is 'an abstraction.' For federal income tax purposes it is sometimes dealt with as though it had a separate existence. . . . This is because Congress has seen fit so to deal with the trust. This entity, the trust, from another point of view consists of separate interests, the equitable interest in the 'res of the' beneficiary and the legal interest of the trustee." (*Greenough v. Tax Assessors* (1947) 331 U.S. 486, 493-494 [67 S.Ct. 1400, 91 L.Ed. 1621, 1628, 172 A.L.R. 329, 335-336]; ins. omitted.)

[7]We note also that bank deposits representing credit obligations in foreign banks may be taxed by the state of the owner's residence. (*Fidelity Columbia Trust Co. v. Louisville* (1917) 245 U.S. 54 [38 S.Ct. 30, 62 L.Ed. 145].) Two decisions which superficially appear to prohibit property taxes imposed

residence afford benefit and protection to the resident beneficiary or trustee.

Moreover, the entire income of a discretionary trust, whether distributed or not, may be taxed by the state where all trustees reside, since that state provides to the trustees the protection requisite to the receipt and control of the disposition of trust income. (*Guaranty Trust Co. v. Virginia* (1938), 305 U.S. 19 [59 S.Ct. 1, 83 L.Ed. 10].) Likewise, the state of the beneficiary's residence may tax the beneficiary on income currently paid to him by a trust held and administered by a trustee in another state: "The beneficiary is domiciled in Massachusetts, has the protection of her laws, and there receives and holds the income from the trust property." (*Maguire v. Trefry* (1920) 253 U.S. 12, 17 [40 S.Ct. 417, 64 L.Ed. 739, 751].) In similar fashion, the beneficiary's state of residence may properly tax the *trust* on income which is payable in the future to the beneficiary, although it is actually retained by the trust, since that state renders to the beneficiary that protection incident to his eventual enjoyment of such accumulated income.

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by the state of the beneficiary's residence upon trust corpus turn upon different principles of law than those which are here applicable. *Brooke v. Norfolk* (1928) 277 U.S. 27 [48 S.Ct. 422, 72 L.Ed. 767]; dealt with inequities which might result if the tax were not apportioned and thus precluded a life beneficiary's state of residence from exacting a property tax based upon the full value of trust intangibles, when the trust was being administered in a different state. *Senior v. Braden* (1935) 295 U.S. 422 [55 S.Ct. 800, 79 L.Ed. 1520, 100 A.L.R. 794], prohibited the state of the beneficiary's residence from imposing a property tax upon a trust corpus of *real* property situated in another jurisdiction, construing it as an attempt to impose taxes upon realty located beyond the taxing state's jurisdiction. These decisions do not inhibit taxation by the state of the beneficiary's residence upon the income of a trust administered for the beneficiary in another jurisdiction.

The tax imposed by California upon the beneficiary is constitutionally supported by a sufficient connection with, and protection afforded to, plaintiff as such beneficiary. Plaintiff in the instant case has, in his role as beneficiary during the years of his residence in this state, enjoyed the protection accorded by California for his eventual receipt of these assets. California grants the beneficiary the interim protection of its laws so that he may ultimately obtain the benefit of the accumulated income. Nor was plaintiff protected only in his personal welfare by the State of California which extended the shelter of its governmental institutions over plaintiff's legal interests as well. If plaintiff had failed to survive to age 40, his trust interest would have been distributed to his heirs who were related by blood to the settlor, special provisions being made for plaintiff's wife; these persons, his family, resided in California. Plaintiff and his family during their residence here thus enjoyed the protection of California's courts in the enforcement of the spendthrift provisions which insured against improvident or involuntary transfers of the equitable interests. (*Sinclair v. Crabtree* (1931) 211 Cal. 524 [296 P. 79]) *Kelly v. Kelly* (1938) 11 Cal.2d 356, 365 [79 P.2d 1059, 119 A.L.R. 71].) Plaintiff further could enlist the aid of California courts to enforce his equitable rights or redress trustee misconduct. (See *McElroy* (1948) 32 Cal.2d 828, 831 [198 P.2d 683]; *Estate of Knox* (1942) 52 Cal.App.2d 338, 348 [126 P.2d 108].)

California thus became entitled to claim reciprocal obligations for "protection which it has afforded . . . ." and "benefits which it has conferred by the fact of being an orderly, civilized society. . . . . The simple but con-

trolling question is whether the state has given anything for which it can ask return. . . . The fact that a tax is contingent upon events brought to pass without a state does not destroy the nexus between such a tax and transactions within a state for which the tax is an exaction." (*Wisconsin v. J. C. Penney Co.* (1940) 311 U.S. 435, 444-445 [61 S.Ct. 246, 85 L.Ed. 267, 270-271, 130 A.L.R. 1229, 1233].) Plaintiff's residence here confers the essential "minimum connection" (*Miller Brothers Co. v. Maryland* (1954) 347 U.S. 340, 344 [74 S.Ct. 535, 98 L.Ed. 744, 748]) necessary for due process of law.

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[8]The state where the owner of a legal or equitable interest in the subject matter of a tax resides thus acquires the authority to impose tax liability. The trust and its income are within California taxing jurisdiction because the owner of the equitable interest resides here and receives the benefit and protection of this state's governmental institutions. "[T]he power to tax intangibles [is] not restricted to one State whether 'we regard the right of a state to tax as founded on power over the object taxed . . . through dominion over tangible or over persons whose relationships are the source of intangible rights, or on the benefit and protection conferred by the taxing sovereignty, or both.'" (*State Tax Com. v. Aldrich* (1941), 316 U.S. 174 [62 S.Ct. 1008, 86 L.Ed. 1358; 139 A.L.R. 1436], relying upon and quoting from *Curry v. McCanless* (1939) 307 U.S. 357, 367-368 [59 S.Ct. 900, 83 L.Ed. 1339, 1347-1348, 123 A.L.R. 162, 170-171].) "[T]he existence of different forms of ownership interests in intangible personal property may make such intangibles amenable to taxation by more than one sovereignty, and that 'double taxation,' that is, taxation of such different ownership in the same property, even though in part overlapping, is not in itself a violation of the due process clause of the Fourteenth Amendment. . . . The right of Pennsylvania to tax property which, in the view of the law, is within its jurisdiction cannot be denied or impaired because another state also may have the right to tax one of its own residents who enjoys another kind of ownership in the funds constituting the trust res." (*Stewart v. Pennsylvania* (1940) 338 Pa. 9, 17-18 [12 A.2d 444]; affd. in *Stewart v. Pennsylvania* (1941) 312 U.S. 649 [61 S.Ct. 445, 85 L.Ed. 1101].)

Indeed, to hold that California could not levy this tax upon the beneficiary when the trust is distributed to him would expose this state to serious impediments in the collection of its taxes. The purpose of section 18106 of the Revenue and Taxation Code in imposing upon the beneficiary at the time of the trust distribution his personal obligation to pay taxes due, but unpaid, by the trust is to avoid the difficulties which the state might otherwise encounter in attempting to enforce tax collection directly against foreign trustees. (See *Hanson v. Denckla* (1957) 357 U.S. 235, 250-255 [78 S.Ct. 1228, 2 L.Ed.2d 1283, 1295-1299], and *Atkinson v. Superior Court* (1957) 49 Cal.2d 338 [316 P.2d 960].) The transferee tax thus levied assures this state that resident beneficiaries of the trusts administered elsewhere obtain no special advantage over California taxpayers.[9]

Nor does the possibility of taxation upon such income by more than one state impair the state's right to exact its own income taxes fixed pursuant to valid standards.[10] Even though the trust may be administered in

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[9]"[W]hile the complexity of the trust itself and of the relations of the parties thereto complicates the problem of effective taxation, it should not obstruct the claims of a state to tax trust income, so far as possible, as it would in the absence of a trust. Trust income is accorded protection in its production, receipt and enjoyment to the same extent as other income; it measures in like manner ability to pay. It should, therefore, be taxed so far as possible upon the same basis. If the obstacles interposed by the trust device are to be circumvented, *jurisdiction to tax should be found wherever substantial claims to tax are reinforced by effective power to compel payment.*" (Italics added.) (Traynor, *State Taxation of Trust Income* (1937) 22 Iowa L.Rev. 268, 271-272.)

[10]The state's sovereign power to tax extends to the taxation of income of nonresidents derived from sources within this state (*Shaffer v. Carter* (1920) 252 U.S. 37 [40 S.Ct. 221,

another jurisdiction by a trustee residing outside the state of the beneficiary's residence, that state may levy its state personal income tax on current trust income distributions to him. (*Maguire v. Trefry* (1919) 253 U.S. 12, *supra.*) California may tax the entire income of a discretionary trust administered by a resident trustee whether he elects to distribute any part of such income or not, even though income which the trust distributes to an out-of-state beneficiary may also be subject to taxation elsewhere. (*Guaranty Trust Co. v. Virginia* (1938) 305 U.S. 19, 22 [59 S.Ct. 1, 83 L.Ed. 16].)

We conclude that California could constitutionally tax plaintiff as the resident beneficiary upon the accumulated income when it was distributed to him. But plaintiff in the instant case was simultaneously beneficiary and a trustee. No possible doubt attaches to California's constitutional power to tax plaintiff as a trustee. His secondary role as a trustee reinforces the independent basis of taxing plaintiff as beneficiary. Having avoided the payment of this state's tax upon the trust income over the previous years, plaintiff is *a fortiori* liable under section 18100.

As a consequence, plaintiff is liable for taxes to which the trust was subject on the income it accumulated for the years 1946 through 1950 since these taxes remained unpaid by the trust when plaintiff received the distribution in 1951.

64 L.Ed. 445]) as well as the income of residents derived from sources outside this state (*Lawrence v. State Tax Com.* (1932) 286 U.S. 276 [52 S.Ct. 556, 76 L.Ed. 1102, 87 A.L.R. 374]; *New York ex rel. Cohn v. Graves* (1936) 300 U.S. 308 [57 S.Ct. 466, 81 L.Ed. 666, 108 A.L.R. 721]; see also *Buchanan v. Tax Com.* (1945) 195 Okla. [154 P.2d 977].)

The case is remanded with instructions to the trial court that plaintiff's tax liability should be recomputed in conformance with this opinion. Each side shall bear its own costs on appeal.

Gibson, *C. J.*, Traynor, *J.*, Schauer, *J.*, McComb, *J.*, Peters, *J.*, and Peek, *J.*, concurred.

Opinion of the District Court of Appeal.

[Civ. No. 26134. Second Dist., Div. Three. May 24, 1963.]

Robert P. McCulloch, Plaintiff and Appellant, v. Franchise Tax Board, Defendant and Respondent.

Appeal from a judgment of the Superior Court of Los Angeles County. Jesse J. Frampton, Judge. Reversed with directions.

Action to recover personal income tax paid to the state on income distributed from an out-of-state trust. Judgment for defendant reversed with directions.

Brady & Nossaman, Walter L. Nossaman and Joseph L. Wyatt, Jr., for Plaintiff and Appellant.

Stanley Mosk, Attorney General, Dan Kaufmann, Assistant Attorney General, Jay L. Shavelson and Harry W. Low, Deputy Attorneys General, for Defendant and Respondent.

Ford, *J.*—The plaintiff, as beneficiary of a trust, received in 1951 a distribution of income of the trust which had been accumulated in the years 1946 to 1950, inclusive.[1] The State of California computed and as-

[1]The distribution was made as of May 9, 1951, and included income received by the trust in 1951. As to that income, the plaintiff concedes that the amount received by him was properly included as part of his taxable income for the year 1951.

sessed an additional personal income tax for the year 1951 because of that distribution. Having paid the amount assessed and having been denied a refund, the plaintiff brought this action for the recovery of the payment. (Rev. & Tax. Code, §19082.) The trial court determined that the tax was imposed in accordance with the applicable law. The plaintiff has appealed from the judgment.

The facts are not in dispute. The plaintiff has been a resident of the State of California at all times since January 1946. During the period of time involved in this case (1946-1951) he resided in the County of Los Angeles with his wife and four minor children. The trust from which the distribution was made was one created pursuant to the will of the plaintiff's grandfather, who was not a resident of California at the time of his death. During the years herein relevant, the plaintiff was one of the trustees. The other trustees were his brother, a resident of Missouri who did not do any business or own any property in the State of California, and St. Louis Union Trust Company, a Missouri corporation not authorized to transact business in California and not in fact transacting any business or owning any property in California.

Pertinent provisions of the trust will be stated. It was provided in part as follows: "As my grandchildren respectively become twenty-five years of age, my Trustees may thereafter from time to time, pay to, expend or have expended for them such part of the net income of their respective portions held in trust, as may be necessary or advisable to assist them in business, professionally or otherwise." Immediately thereafter was a paragraph under which the trustees were em-

powered, "subject to the discretionary power with which they are hereinafter entrusted and charged," to make distributions of cash or securities in specified amounts to a grandchild when that grandchild reached the respective ages of 25, 30 and 35 years. A further provision was: "As my grandchildren respectively become forty years of age,* the trusts as to them shall be terminated, and the Trustees shall, subject to the discretionary powers hereinafter conferred upon them convey, transfer, deliver and pay to them the principal and any accumulated income of the apportionments then held in trust for said grandchildren, respectively, . . ."

Paragraph 15 of the will was as follows: "In case any beneficiary of any of the trusts hereby created for my grandchildren or my heirs-at-law, at the time when any payment becomes due to him, her or them, pursuant to the foregoing provisions, are not, in the judgment of the Trustees, of such habits and of such mental or business capacity, as to be able to prudently manage and properly care for the same, then the Trustees may, and should, withhold part, or all, of such sum, and may continue to hold, manage, invest and reinvest the same, and pay to, expend or have expended for such beneficiary, the income, or such part thereof, or withheld principal, as may be reasonable in the discretion of the Trustees, for the maintenance and pleasure of such beneficiary, or of their family or of those dependent upon them, or the Trustees, in their discretion, may from time to time pay any beneficiary, such amounts with which they think such beneficiary may be prudently entrusted, the remainder to be held for investment and reinvestment, as aforesaid, until such

*The plaintiff became 30 years of age on May 9, 1951.

time as the Trustees may deem it prudent and proper to make additional or full payment."

The trust contained a prohibition against the anticipation of payments by a beneficiary or alienation or disposition of his or her interest in the trust.

In an earlier section of the will it was also provided that "the net income of the trust estate, or of the respective trusts not disbursed from year to year shall be added to the principal and thereafter invested and disbursed as herein authorized." The following provision was made with respect to the effect of the death of a grandchild of the trustor: "After the death of any of my grandchildren during the period of their respective trusts, the income and principal of the portions held in trust for them, respectively, shall by my Trustees be thereafter held for their respective heirs-at-law, who are by blood related to me; provided that [provision is then made for support of the widow of a deceased grandchild]. . . ."

In the will under which the trusts were created it was provided as follows: "The custody, collection, accounting and distribution of the assets and income of my estate shall reside with the Trust Company Executor and or Trustee for and so long as there shall be a Trust Company serving in that behalf." A further provision was that the individual trustees (who in the period herein involved were the plaintiff and his brother) should have the "right and power" to substitute for the St. Louis Union Trust Company, as trustee, "any reputable and experienced Trust Company, wheresoever located"; a subsequent substitution of a like nature could thereafter be made "but not more frequently than once in two years after the first substitution."

It was further provided that: "Before any such substituted Trust Company shall so act, the selection shall have been approved and confirmed by the proper court having jurisdiction in the premises." No such substitution appears to have been made.

The trust corpus for the years 1946 to 1951 consisted of bonds issued by municipalities, counties and districts of various states, including California, stocks and bonds issued by corporations doing business throughout the United States, including some corporations which were incorporated and did business within the State of California, and real estate which was not located in California. The property in each category was of substantial value.

The problem presented in this case must be resolved in the light of the statutory law in effect in the years 1946-1951. The State of Missouri received payments of income tax with respect to the income of the trust for the years 1946 to 1950, inclusive, but no income tax of that nature was paid to the State of California. The plaintiff, as beneficiary, did not receive any of the income herein involved in the year in which it was paid to the trust and he had no absolute right to require that all of such income received by the trust in any of those years be currently distributed to him. Under the Revenue and Taxation Code as it existed in that period, if any tax was payable with respect to income which was to be accumulated it was imposed upon the trust. (See Sabine, *Constitutional and Statutory Limits on the Power to Tax* (1960) 12 Hastings L.J. 23, 38-39.) Section 18101 of the Revenue and Taxation Code[3] was in part as follows: "The taxes imposed

[3]The substance of that section is now found in section 17731

by this part upon individuals apply to the income of estates or of any kind of property held in trust . . ., including: (a) Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interest, and income accumulated or held for future distribution under the terms of the will or trust. . . . (d) Income which, in the discretion of the fiduciary, may be either distributed to the beneficiaries or accumulated."

Since the plaintiff was the only trustee who was a resident of the State of California in the pertinent period of time and since he was a beneficiary as to money or property distributable to him, section 18101 must be considered together with sections 18102 and 18103.[4] Section 18102 was as follows: "Except as otherwise provided in articles 2 and 4 of this chapter, the income of an estate or trust is taxable to the estate or trust. The tax applies to the entire net income of an estate, if the decedent was a resident, regardless of the residence of the fiduciary or beneficiary, and to the entire net income of a trust, if the fiduciary or beneficiary is a resident, regardless of the residence of the settlor." Section 18103 was as follows: "Where the taxability of income of a trust depends on the residence of the fiduciary and there are two or more fiduciaries for the trust, the income taxable under section 18102 shall be apportioned according to the number of fiduciaries resident in this State pursuant to rules and regulations prescribed by the commissioner." Section 18105 provided in part as follows: "Taxes on income

[4]The provisions currently in effect are found in sections 17742 and 17743 of the Revenue and Taxation Code.

of an estate or trust which is taxable to the estate or trust . . . shall be paid by the fiduciary."[3]

It is essential to determine whether any of the income received by the trust in the years noted and accumulated for future distribution was validly subject to the imposition of income tax by the State of California under the statutory provisions set forth hereinabove because, if such taxability did exist, the provisions of section 18106 (now found in section 17745) of the Revenue and Taxation Code are relevant. Section 18106 was as follows: "If, for any reason, the taxes imposed on income of a trust which is taxable to the trust because the fiduciary or beneficiary is a resident of this State are not paid when due and remain unpaid when such income is distributable to the beneficiaries, or in case the income is distributable to the beneficiaries before the taxes are due, if the taxes are not paid when due, such income shall be taxable to the beneficiaries when distributable to them except that in the case of nonresident beneficiaries such income shall be taxable only to the extent it is derived from sources within this State."

A provision, such as was contained in section 18106 of the Revenue and Taxation Code, which attaches to the distributee of accumulated income a liability for income tax when the trust has failed to discharge its obligation to the state with respect to such income is warranted as a reasonable device by means of which the payment of taxes may be assured. (See *McCreery v. McColgan*, 17 Cal. 2d 555, 560 [110 P. 2d 1051, 133 A. L. R. 800]; *Edison California Stores, Inc. v.*

[3]The current provision is found in the last paragraph of section 17731 of the Revenue and Taxation Code.

McColgan, 30 Cal. 2d 472, 476 [183 P. 2d 16].) The question to be determined in this case is whether section 18106 could be validly applied to the factual situation involved herein.

As has been noted, the plaintiff was entitled to receive a distribution from the trust of principal, including additions thereto by reason of accumulated income, only upon survival to a designated age. Accordingly, there was no assurance at any time prior to his reaching the age of 40 years that he would actually receive the accumulated income involved in this case. Prior to distribution thereof, a nondefeasible right thereto did not vest in him. (See *Commissioner of Corporations & Taxation v. Simmon*, 292 Mass. 507 [198 N.E. 741, 102 A.L.R. 273]; *Mahler v. Conway*, 230 Wis. 582 [285 N.W. 772].) The question which must be determined is whether the fact that he resided in California gave this state a constitutional basis for assessing an income tax against the trust for the years in question; if not, section 18106 was inapplicable by its own terms since there were no taxes which had become due. It has been said with respect to that problem: "The constitutional validity of a tax by the state of residence of the trustee on accumulated net income appears to have acceptance by the United States Supreme Court. The Court, however, has not yet had occasion to decide the validity of a tax with respect to accumulated income where the trustee is a nonresident and the tax is founded on residence of the beneficiary." (Sabine: *Constitutional and Statutory Limits on the Power to Tax* (1960), *supra*, 12 Hastings L.J. 23, 39-40.) Under the circumstances of the present case, taxation by the State of California of the trust with respect to income

received and accumulated in any one of the years 1940-1950 could not be predicated solely on the residence of the plaintiff in California during such years because the necessary nexus required by the concept of due process did not then exist. (See *Miller Bros. Co. v. Maryland*, 347 U. S. 340, 343-345 [74 S. Ct. 535, 98 L. Ed. 744, 747-748].)[6] The remaining question, therefore, is whether, in view of the fact that one of the trustees was a California resident, the State of California had jurisdiction to impose an income tax on one-third of the income which was accumulated rather than currently distributed to the beneficiary. (See Rev. & Tax. Code, former § 18103, *supra*.)

Guidance in the solution of the problem of jurisdiction to tax is found in the reasoning of the Supreme Court in *Greenough v. Tax Assessors*, 331 U.S. 486 [67 S. Ct. 1400, 91 L.Ed. 1621, 172 A.L.R. 329], although the court was there concerned with a property tax. In that case, under a testamentary trust two trustees held intangible personalty for a life beneficiary and undetermined future beneficiaries. The evidences of the intangible property (shares of capital stock of the Standard Oil Company of New Jersey) were at all times in New York. The life beneficiary and one of the trustees were residents of New York. The other trustee resided in Rhode Island, but he did not exercise his powers as trustee in Rhode Island during the period in question. The City of Newport, Rhode Is-

[6] In *Miller Bros. Co. v. Maryland*, *supra*, Mr. Justice Jackson stated (347 U.S., at pages 344-345 [74 S.Ct. 535, 98 L.Ed. 744, 748]): "But the course of decisions does reflect at least consistent adherence to one time-honored concept: that due process requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax."

land, assessed a personal property tax of $50 against the resident trustee upon one-half of the value of the corpus of the trust. The trustees asserted that Rhode Island could not tax the resident trustee's proportionate part of the trust intangibles merely because of his residence. It was urged that such a tax was unconstitutional under the due process clause because it exacted payment measured by the value of property wholly beyond the reach of Rhode Island's power and to which that state did not give protection or benefit. In the course of rejecting that contention, Mr. Justice Reed stated (331 U.S., at pp. 495-496 [67 S.Ct. 1400, 91 L.Ed. 1621, 1628-1629, 172 A.L.R. 329, 336-337]): "The Supreme Court of Rhode Island considered the argument that the laws of the state afforded no benefit or protection to the resident trustee. Although nothing appeared as to any specific benefit or protection which the trustee had actually received, it concluded that the state was 'ready, willing and capable' of furnishing either 'if requested.' A resident trustee of a foreign trust would be entitled to the same advantages from Rhode Island laws as would any natural person there resident. *Greenough v. Tax Assessors, supra* (71 R.I. 477 at p. 488, 47 A.2d 625, at p. 631). There may be matters of trust administration which can be litigated only in the courts of the state that is the seat of the trust. . . . But when testamentary trustees reside outside of the jurisdiction of the courts of the seat of trust, third parties dealing with the trustee on trust matters, or beneficiaries may need to proceed directly against the trustee as an individual for matters arising out of his relation to the trust. Or the resident trustee may need the benefit of the Rhode Island law to enforce trust claim against a Rhode Island resident.

. . . Consequently, we must conclude that Rhode Island does offer benefit and protection through its law to the resident trustee as the owner of intangibles." Mr. Justice Reed also stated (331 U.S., at page 498 [67 S.Ct. 1400, 91 L.Ed. 1621, 1630, 172 A.L.R. 329, 338]): "Nor do we think it constitutionally significant that the Rhode Island trustee is not the sole trustee of the New York trust. The assessment, as the statute in question required, was only upon his proportionate interest, as a trustee, in the *res*. Whatever may have been the character of his title to the intangibles or the limitations on his sole administrative power over the trust, the resident trustee was the possessor of an interest in the intangibles, sufficient, as we have explained, to support a proportional tax for the benefit and protection afforded to that interest by Rhode Island."

In the light of the reasoning of the *Greenough* case, this court is not free to interfere with the clear legislative intent to impose upon a trustee resident in California the duty of paying income tax upon a proportionate amount of the income received by the trust. (Cf. *Mackay v. San Francisco*, 128 Cal. 678 [61 P. 382].)

While former section 18106 of the Revenue and Taxation Code was applicable to the accumulated income for the years 1946-1950 which was received by the plaintiff, as beneficiary, in 1951, that section could only apply to that portion of the income (one-third) which was subject to tax in each year pursuant to former sections 18101-18103 of the Revenue and Taxation Code. The computation and assessment of which the plaintiff complains appears to have been based on *all*

of such income. Consequently, it is necessary to remand the case to the superior court for the purpose of determining the proper amount of the plaintiff's obligation under former section 18106 of the Revenue and Taxation Code in accordance with the law as herein set forth.

The judgment is reversed and the cause is remanded for a new trial.

Shinn, *P. J.*, concurred.

Files, *J.*, Dissenting.—I would affirm the judgment. Omitting any discussion of whether, under the statute, plaintiff was in 1949-50 "the beneficiary" or merely one of several beneficiaries (since the decision does not turn upon it), we face squarely the constitutional question of whether income accumulated by this trust may be taxed by California upon the ground that the beneficiary is a California resident. It seems to me that the residence of the beneficiary is a sufficient "nexus" to justify a tax on such income, or upon a proportion of such income if the California resident is not the sole beneficiary. This is what California has claimed the right to do by legislation which has been on the books since 1935 (Stats. 1935, ch. 329, § 12, subd. (b)(3)(D); Rev. & Tax. Code, § 17742).

The fact that California may be at a disadvantage in enforcing collection directly against a foreign trustee need not be deemed a constitutional limitation on California's power to impose equitable taxation upon its residents. After all, the tax is imposed not upon the trustee, but upon the trust estate. The concept of a trust as a separate taxable entity does not require that the trust be denominated a foreign person exempt from

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California taxation. For this purpose a trust is better described as a fund owned by a California resident.

The readily enforceable provision for a substitute tax imposed upon the distributee when the income eventually reaches him is a reasonable means of seeing that the beneficiary of a "foreign" trust obtains no special advantage over other California taxpayers. No double taxation is involved because California gives credit for the taxes paid by the trustee in Missouri. Subject to that limitation, there is no reason why a California resident whose wealth accumulates under the administration of a Missouri trustee should contribute less to the support of this state than should his fellow citizen whose wealth is managed by a local trustee.

Findings of Fact and Conclusions of Law.

In the Superior Court of the State of California, in and for the County of Los Angeles.

Robert P. McCulloch, Plaintiff, v. Franchise Tax Board, Defendant. No. 740,235.

This cause came on regularly for trial before the Court sitting without a jury, the Honorable Jesse J. Frampton, Judge, Presiding, Walter L. Nossaman, Esq., and Joseph L. Wyatt, Jr., appearing for plaintiffs, and Stanley Mosk, Attorney General of the State of California, by Harry W. Low, Deputy Attorney General, appearing for defendant. A Joint Pre-Trial Statement and Stipulation of Facts signed by counsel of the respective parties was filed and received by the Court, together with a Supplemental Stipulation of Facts, and the case was thereafter submitted subsequent to the presentation of points and authorities and hearing of

oral argument. The Court having considered the evidence and being fully advised in the premises, now makes its Findings of Fact and Conclusions of Law as follows:

I

Plaintiff is an individual. He is now and has been a resident of the County of Los Angeles, State of California, at all times since January, 1946. Plaintiff is now and was a citizen of the United States of America throughout the period January 1, 1946 to May 10, 1951. Plaintiff was married to and lived with Barbara B. McCulloch. Barbara B. McCulloch was also a resident of Los Angeles County, State of California, during the period January 1, 1946 to May 9, 1951. Plaintiff Robert P. McCulloch and his wife Barbara B. McCulloch, had four children, namely, Robert P. McCulloch, Jr., born June 29, 1936; Richard B. McCulloch, born January 23, 1938; Mary McCulloch, born December 31, 1946; and Barbara McCulloch, born August 18, 1948, who from the time of their birth until May 9, 1951, resided with their parents.

II

During the calendar year 1951, and all other years relevant hereto, plaintiff kept his books and reported his income for income tax purposes on the cash basis of accounting and on the basis of calendar taxable years.

III

Plaintiff timely filed on May 23, 1952, a California Individual Income Tax Return for the calendar and taxable year 1951 with the Franchise Tax Board (having received from defendant an extension to and including

June 15, 1952, of the time within which to file said return, otherwise due April 15, 1952). Said return showed a tax due of $16,594.29 which plaintiff timely paid.

IV

On March 29, 1957, defendant issued "Notice of Personal Income Tax Proposed to be Assessed," Number 92361, which proposed an additional assessment of personal income tax in the amount of $22,575.79 tax, plus interest at the rate of 6% on the principal tax from April 15, 1952 to the date of payment. A true copy of the Notice is attached to the Complaint as Exhibit A.

V

On January 15, 1959, plaintiff paid to the Franchise Tax Board the amount of $31,619.71 in respect of the additional assessment and an additional amount of $103.90 as additional interest to date of payment. The sum of $31,619.71 consisted of $22,575.79 tax plus interest at the rate of 6% per annum from April 15, 1952 to the date of assessment, in the sum of $9,043.92. No penalties were assessed.

VI

On December 9, 1959, plaintiff timely filed a Claim for Refund of personal income taxes paid for the calendar and tax year 1951 in the amount of $31,723.61, or any greater amount legally refundable, with interest as provided by law. Said claim for refund, a copy of which is attached to the complaint on file herein as Exhibit B thereof, contained a statement of reasons for allowance of claim, rider "A" of said claim.

VII

The Franchise Tax Board mailed a notice of action on said claim denying said claim on its entirety on January 18, 1960. The complaint herein was filed within ninety days of said date, on February 19, 1960.

VIII

The proposed additional assessment mentioned in paragraph V above, was based on the Franchise Tax Board's addition to plaintiff's income for the calendar and tax year 1951 of the amount of $453,004.75 received, along with other sums, as a final distribution as of May 9, 1951, from a trust created by John I. Beggs, plaintiff's grandfather, in his will, a copy of which will was attached to the complaint herein as Exhibit C thereof. The income, expenses, distributions to plaintiff, and the amounts of income accumulated under the terms of said trust for the plaintiff during said period from January 1, 1946 to May 9, 1951, are as shown in a schedule of said amounts attached to the Joint Pre-Trial Statement and Stipulation of Facts as Exhibit "A". The total "net income unreported" for the years 1946-1951, totalling $453,004.75 represented income of the trust accumulated during the period January 1, 1946 to May 9, 1951. Plaintiff duly and timely reported the amounts listed in Exhibit "A" as "Distribution Reported" as income of said trust distributed to him during said years and paid the California Personal Income Tax on said amounts.

IX

At all times relevant hereto the trustees of the aforementioned trust and their places of residence were the St. Louis Union Trust Company, a Missouri corpora-

tion not authorized to transact business in California and not in fact transacting any business or owning any property in California; plaintiff, whose residence is set forth in paragraph I above; and John I. B. McCulloch; a resident of Missouri who did not do any business or own any property in the State of California.

X

John I. Beggs, plaintiff's grandfather, was not a resident of the State of California at the time of his death.

XI

The terms of said trust are as set forth in the will and codicil attached to the complaint herein as Exhibit "C" thereto.

XII

Income taxes in the total amount of $4,576.84 were paid by said trust to the State of Missouri in respect of the $453,004.75 mentioned in paragraph VIII above. Said amount was credited in full by defendant in computing plaintiff's tax which is the subject of this action.

XIII

During the years in which the $453,004.75 of trust income mentioned in paragraph VIII above was accumulated by the said trust, no personal income taxe were paid to the State of California by plaintiff individually or by the trustees of said trust in respect to said accumulations.

XIV

Plaintiff became age 40 on May 9, 1951. Testator John I. Beggs was survived by three grandchildren, John I. B. McCulloch, Robert P. McCulloch (plaintiff herein), and Mary Sue McCulloch (now Oakes). At

all times relevant, said John I. B. McCulloch and plaintiff were the individual trustees of all three trusts for said grandchildren, and of all other trusts created by testator's will and codicil, succeeding to all powers originally conferred by said will and codicil upon Richard McCulloch and Lawrence A. Olwell. At all times relevant hereto, said St. Louis Union Trust Company, a Missouri corporation, was the corporate trustee of all trusts created by said will and codicil and the custody, collection, accounting and distribution of the assets and income of the said trusts resided in said St. Louis Union Trust Company.

XV

The trust corpus for the years 1946 through 1951 consisted of bonds issued by municipalities, counties and districts of states throughout the United States, including the State of California; stocks and bonds issued by corporations doing business throughout the United States including some corporations which were incorporated and did business within the State of California, and real estate which was not located in California.

The value of the real property in 1946 was stated to be approximately $12,000,000.00. The stocks of the various corporations were of substantial value and in 1951, prior to distribution, the trust held 455,425 shares of stocks in 95 companies. The total face value of the bonds held in trust for the years 1946 through May 9, 1951, a portion of which bonds were issued

by California municipalities, California public districts and by the State of California) are listed as follows:

Year	Total Face Value	Bonds Issued by California municipalities, California districts and State of California
1946	$7,369,000	$290,000
1947	7,025,000	485,000
1948	4,757,000	279,000
1949	4,834,000	323,000
1950	5,661,000	277,000
1951	5,642,000	277,000

XVI

The Court further finds that each and every allegation of the complaint which is not included in the Stipulation of Facts and Supplemental Stipulation of Facts on file herein, or admitted by the answer, or expressly found to be true in these Findings, is untrue.

Conclusions of Law.

From the foregoing Findings of Fact, the Court makes the following Conclusions of Law:

1. For purposes of former sections 18101-18106 of the California Personal Income Tax Law in effect from 1946 to 1952, the plaintiff was the beneficiary of the trust created under the will of John I. Beggs.

2. The receipt of accumulated income in the sum of $453,004.75 by plaintiff on May 9, 1951, was a receipt of income in 1951 to plaintiff and was not receipt of corpus under the California Personal Income Tax Law

former section 17101 and sections 18101-18106, in effect from 1946 to 1952.

3. The sum of $453,004.75 received by plaintiff was taxable income in 1951 to plaintiff under California Personal Income Tax Law former section 17101 and sections 18101 to 18106.

4. The imposition of the personal income tax with respect to the sum of $453,004.75 distributed to plaintiff and received by him on May 9, 1951 was valid and constitutional under U.S. Constitution amendment 14, §1, and California Constitution Article I, §§1 and 13 and Article XIII, §11.

5. Plaintiff shall take nothing by this action, and defendant have its costs of suit incurred in the sum of $.....

Let Judgment be entered accordingly.

Dated: July 10, 1961.

/s/ Jesse J. Frampton
Judge of the Superior Court

Judgment.

In the Superior Court of the State of California, in and for the County of Los Angeles.

Robert P. McCulloch, Plaintiff, v. Franchise Tax Board, Defendant. No. 740 235.

This cause came on regularly for trial before the Court sitting without a jury, the Honorable Jesse J. Frampton, Judge, Presiding, Walter L. Nossaman, Esq., and Joseph L. Wyatt, Jr., appearing for plaintiff, and Stanley Mosk, Attorney General of the State of California, by Harry W. Low, Deputy Attorney General, appearing for defendant. A Joint Pre-Trial Statement and Stipulation of Facts signed by counsel of the respective parties was filed and received by the Court, together with a Supplemental Stipulation of Facts, and the cause was thereafter submitted subsequent to the presentation of points and authorities and hearing of oral argument. The Court having made and signed its Findings of Fact and Conclusions of Law herein, and ordered that judgment be entered in accordance therewith,

Now, Therefore, It Is Hereby Ordered, Adjudged and Decreed that plaintiff take nothing by his complaint and that defendant have judgment for its costs incurred herein in the sum of $7.50.

Dated July 10, 1961.

/s/ Jesse J. Frampton
Judge of the Superior Court

APPENDIX B.

Statutes Involved* (pre-1955).

"Section 17101. *Definition of Gross Income.* Gross income includes gains, profits, and income derived from salaries, wages or compensation for personal service, of whatever kind or in whatever from paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rents, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

"Section 18101. *Taxation of estates and trusts, income includible.* The taxes imposed by this part upon individuals apply to the income of estates or of any kind of property held in trust (other than so-called Massachusetts trusts), including:

"(a) Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests, and income accumulated or held for future distribution under the terms of the will or trust.

"(b) Income which is to be distributed currently by the fiduciary to the beneficiaries, and income collected by a guardian of an infant which is to be held or distributed as the court may direct.

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*Former Sections 17101, 18101, 18102, 18103, 18104 and 18106 are now (since 1955) Sections 17071 (substantially similar) 17731 (subs. (b) added), 17742, 17743, 17744, 17745. Section 18105 is (in part) incorporated in Section 17731(b).

"(c) Income received by estates of deceased persons during the period of administration or settlement of the estate.

"(d) Income which, in the discretion of the fiduciary, may be either distributed to the beneficiaries or accumulated.

"Section 18102. *Estate or trust, taxability.* Except as otherwise provided in Articles 2 and 4 of this chapter, the income of an estate or trust is taxable to the estate or trust. The tax applies to the entire net income of an estate, if the decedent was a resident, regardless of the residence of the fiduciary or beneficiary, and to the entire net income of a trust, if the fiduciary or beneficiary is a resident, regardless of the residence of the settlor.

"Section 18103. *Trust, taxability dependent upon residence of fiduciary.* Where the taxability of income under this chapter depends on the residence of the fiduciary and there are two or more fiduciaries for the trust, the income taxable under Section 18102 shall be apportioned according to the number of fiduciaries resident in this State pursuant to rules and regulations prescribed by the Franchise Tax Board.

"Section 18104. *Trust, taxability dependent upon residence of beneficiary.* Where the taxability of income under this chapter depends on the residence of the beneficiary and there are two or more beneficiaries of the trust, the income taxable under Section 18102 shall be apportioned according to the number and interest of beneficiaries resident in this State pursuant to rules and regulations prescribed by the Franchise Tax Board.

"Section 18105. *Estate or trust taxes, charge upon same.* Taxes on income of an estate or trust which is taxable to the estate or trust are a charge upon the estate or trust and shall be paid by the fiduciary.

"Section 18106. *Trust taxes, liability of beneficiaries.* If, for any reason, the taxes imposed on income of a trust which is taxable to the trust because the fiduciary or beneficiary is a resident of this State are not paid when due and remain unpaid when such income is distributable to the beneficiaries, or in case the income is distributable to the beneficiaries before the taxes are due, if the taxes are not paid when due, such income shall be taxable to the beneficiaries when distributable to them except that in the case of nonresident beneficiaries such income shall be taxable only to the extent it is derived from sources within this State."

UNITED STATES CONSTITUTION, AMENDMENT 14

SECTION 1:

"All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside. No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws."

Office-Supreme Court, U.S.
FILED
OCT 1 1964
JOHN F. DAVIS, CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1964

No. 472

ROBERT P. McCULLOCH,
Plaintiff and Appellant,

vs.

CALIFORNIA FRANCHISE TAX BOARD,
Defendant and Appellee.

On Appeal from the Supreme Court of the State of California

Motion to Dismiss or Affirm

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On Appeal from the Supreme Court of the State of California

Motion to Dismiss or Affirm

Appellee, pursuant to Rule 16 of the Revised Rules of the Supreme Court of the United States, hereby moves the Court to dismiss this appeal or to affirm the judgment of the California Supreme Court for the following reason: There is no substantial federal question presented as a basis of jurisdiction in this Court, inasmuch as the questions presented have been foreclosed by previous decisions of this Court.

STATEMENT OF THE CASE AND THE FACTS

This case concerns a tax collected from appellant upon his receipt of accumulated income in California. The appellant is the sole beneficiary and one of three co-trustees of a trust. From this trust he received a distribution of accumulated income in 1951 which is the subject of this dispute. The appellant and his family were residents of California from 1946 to 1951.

There were two other trustees, namely: appellant's brother, a resident of Missouri; and the St. Louis Trust Company, a Missouri corporation. The corporate trustee was responsible for the custody and accounting of the income and corpus in the trust.

Under the terms of the trust, it was within the discretion of the trustees to distribute some or all of the income as it was earned. Undistributed income was to be accumulated and then distributed when the appellant reached age forty (on May 9, 1951), providing he was financially responsible. Upon distribution the trust was to terminate.

This case puts in issue California's comprehensive system for taxation of all trusts.[1] The California law seeks to tax all income, including that income accumulated for the benefit of persons with contingent interests and income which is distributed or accumulated at the discretion of the fiduciary. (Revenue and Taxation Code section 18101).[2] California law requires "the trust" to pay taxes due on the income

1. The relevant California Revenue and Taxation Code sections 18101 to 18106 are set forth in Appendix A.

2. All references are to the California Revenue and Taxation Code of 1951 unless otherwise specified.

earned. Income is taxable if the fiduciary or the beneficiary is a resident, regardless of the residence of the settlor. If there is more than one beneficiary or fiduciary and only some of the beneficiaries or fiduciaries are residents of California, the income taxable by California is apportioned. (Sections 18102-18104.) Section 18106[3] provides:

> "If, for any reason, the taxes imposed on income of a trust which is taxable to the trust because the fiduciary or beneficiary is a resident of this state are not paid when due and remain unpaid when such income is distributable to the beneficiaries . . . such income shall be taxable to the beneficiaries when distributable to them. . . ."

Section 18106 provides that if the trustees of the trust fail to pay the tax for the trust annually as the income is earned, the California resident beneficiary becomes liable for such tax when the previously earned income is distributed to him. The distributee-beneficiary bears the statutory liability, as a transferee, for the taxes which were due from the trust. The beneficiary must pay the tax that the trustee should have paid on behalf of the trust as that income was earned. (*McCulloch v. Franchise Tax Board*, 61 Cal. 2d ..... ; 390 P.2d 412, 416.)

The trust did not pay any income taxes to the State of California during the years 1946 to 1950, but did pay some income taxes to Missouri. The accumulated income distributed in 1951 was included in appellant's 1951 taxable income and he was assessed accordingly. Pursuant to the California Income Tax Law, the income taxes paid to Missouri were credited to the beneficiary's liability of 1951.

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3. The California Supreme Court has described section 18106 as "one of the foundation stones in the structure of rules applying California income taxes to trust income." *Id.*, 61 Cal. 2d ..... ; 390 P.2d 412, 416.

Appellant paid the California income taxes assessed and thereafter sued for a refund in the Los Angeles Superior Court. The Superior Court ruled against the appellant, from which judgment he appealed. The matter was ultimately heard by the California Supreme Court.

The California Supreme Court, in a unanimous decision, ruled that the accumulated income was taxable to the beneficiary upon his receipt thereof in 1951. The Supreme Court rejected the appellant's constitutional arguments. The Supreme Court held that based upon the proper construction of section 18106, the amount taxable to the beneficiary should be no greater than the amount the trust would have paid had the trust paid income tax to California each year while the income was being earned from 1946 to 1950. The Supreme Court remanded the case to the Superior Court to compute the tax accordingly. (*McCulloch v. Franchise Tax Board, supra.*)

After denial of the petition by the appellant for rehearing in the California Supreme Court this appeal follows.

ISSUE PRESENTED

Does the appellant's residency in California in his capacity as the contingent beneficiary and as one of three trustees, provide sufficient nexus to income accumulated by an out-of-state trust so as to allow California to impose a tax upon the appellant's receipt of that income in California?

Appellee contends that the California Supreme Court correctly applied the decisions of this United States Supreme Court in determining that there was sufficient nexus by reason of the appellant's residency.

This Appeal Does Not Present a Substantial Federal Question.

A. THERE IS NO VIOLATION OF THE DUE PROCESS CLAUSE SINCE THERE IS SUFFICIENT NEXUS BETWEEN THE BENEFICIARY AND THE TRUST DURING THE PERIOD OF ACCUMULATION TO TAX THE INCOME WHEN DISTRIBUTED TO APPELLANT IN CALIFORNIA.

The California Supreme Court carefully analyzed the numerous United States Supreme Court cases that have dealt with the question of "nexus." The California Supreme Court concluded, "We find no reason in constitutional principles or in practical application of such principles why the tax founded upon residence of the beneficiary should not be sustained." (*Id.* 61 Cal. 2d .....; 390 P.2d at 418.) As a second constitutional ground for upholding the tax, the California Supreme Court concluded, "But plaintiff in the instant case was simultaneously beneficiary and a trustee. No possible doubt attaches to California's constitutional power to tax plaintiff as a trustee. His secondary role as a trustee reenforces the independent basis of taxing plaintiff as beneficiary." (*Id.* 61 Cal. 2d .....; 390 P.2d at 420.)

Admittedly, this case under *these facts* does present a novel question, but the decisions of the United States Supreme Court by analogy have clearly upheld taxes similar to the one based upon the interest of this beneficiary. If the State of California can impose a tax upon this "out-of-state trust" during accumulation, it can collect this tax from the beneficiary when he receives this distribution. (*Phillips v. Com'r of Internal Revenue*, 283 U.S. 589.) It has been held that a state may tax the income *received* by the resident beneficiary from the trust despite the fact that the trust income is earned outside that state. (*Maguire v. Trefry*, 253 U.S. 12; *Lawrence v. State Tax Commission*, 286 U.S. 276; *Guaranty Trust Co. v. Virginia*, 305 U.S. 19.)

This Court has held that a state may tax persons, things or transactions which have "out-of-state elements" if the taxing state has some "minimum connection" to the thing taxed. This "minimum connection" is determined by the nature and extent of the activities of the taxpayer in the taxing state or in the *benefits of protection afforded the taxpayer to the thing taxed.* (*Scripto, Inc. v. Carson*, 362 U.S. 207; *Miller Bros. v. Maryland*, 347 U.S. 340; *Wisconsin v. J. C. Penney Co.*, 311 U.S. 435, 444; *Greenough v. Tax Assessors*, 331 U.S. 486; *Guaranty Trust Co. v. Virginia*, 305 U.S. 19.)

California offered many "benefits and protection" to the appellant as the beneficiary and had many "connections" with the accumulated income and the trust. The California Supreme Court enumerated a few of these "benefits and protection."

> "California grants the beneficiary the interim protection of its laws so that he may ultimately obtain the benefit of the accumulated income. Nor was plaintiff protected only in his personal welfare by the State of California which extended the shelter of its governmental institutions over plaintiff's legal interests as well. If plaintiff had failed to survive to age 40, his trust interest would have been distributed to his heirs who were related by blood to the settlor, special provisions being made for plaintiff's wife; these persons, his family, resided in California. Plaintiff and his family during their residence here thus enjoyed the protection of California's courts in the enforcement of the spendthrift provisions which insured against improvident or involuntary transfers of the equitable interests. (*Sinclair v. Crabtree* (1931) 211 Cal. 524; *Kelly v. Kelly* (1938) 11 Cal. 2d 356, 365.) Plaintiff further could enlist the aid of California courts to enforce his equitable rights or redress trustee misconduct. (See *McElroy v. McElroy* (1948) 32 Cal. 2d

828, 831, *Estate of Knox* (1942) 52 Cal. App. 2d 338, 348.)

"California thus became entitled to claim reciprocal obligations for protection which it has afforded . . ." (*McCulloch* case, 61 Cal. 2d ....., 390 P.2d at 419.)

Moreover, from 1946 to 1951, appellant had the right to receive distributions from income or corpus. These distributions were at the discretion of the trustees with fixed amounts of substantial size going to him at ages 25, 30 and 35. Each year from 1946 to 1951, income ranging from $125,681.00 to $263,785.81, was distributed to appellant. Upon a proper showing to a California court, appellant might have demanded an accounting or more money for business, education, support and reasonable recreation prior to final distribution and termination of the trust.

Since appellant was one of the trustees, the availability of California courts afforded benefits and protections to him prior to termination of the trust in 1951. (See *Greenough* case discussed below.) In fact, the real practical power in the management and control of the trust was in the natural trustees, appellant and his brother. They had the power to remove and substitute the corporate trustees. As the beneficiaries and co-trustees they had the ownership and control of the trust.

Appellant as the beneficiary could have made use of the California courts to redress wrongs, to enjoin acts or enforce contracts against third parties dealing with the trust to the extent such activities arose in California where the trustee refuses to act. Such actions could have, for example, concerned the California municipal bonds and stocks of California corporations. When appellant reached age 35, on May 9, 1946, he could have demanded payment of $350,000 from the trust. Other suits might also have been brought

against appellant as trustee of the accumulated income. Appellant could have requested an accounting through the courts in this State. (See *McElroy v. McElroy*, 32 Cal. 2d 828; *Hardy v. Hardy*, 164 Cal. App. 2d 77 (hearing denied by Sup. Ct. Nov. 2, 1958.) See also, Austin Scott, *Spendthrift Trusts and the Conflicts of Laws*, 77 Harv. L. Rev. 845.)

Under the provisions of the trust, had appellant not survived to age 40, the accumulated income and the corpus would have gone to appellant's children who were related to the settlor by blood, with special provisions for appellant's wife. Appellant's children as blood heirs would have been the beneficiaries, enjoying substantially the same rights and benefits under the trust had appellant lived. During the period of accumulation the trustees could also make reasonable expenditures and payments for the maintenance and pleasure of the beneficiary or in some instances for "their families or those dependent upon them."

Availability of California courts is considered as a significant factor in sustaining a tax against due process objections. See *West Publishing Co. v. McColgan*, 27 Cal. 2d 705, 713, (aff'd 328 U.S. 823), where the court attributed significance to the fact California "maintains courts in which plaintiff enforces payment for the sale of its publication. . . ."

Appellant raises arguments similar to those heretofore rejected by this Court in *Greenough v. Tax Assessors*, 331 U.S. 486 (1946). In that case, Rhode Island was allowed to apply a property tax to a proportionate share of the intangible assets of the trust where the active trustee was in New York, the beneficiaries were all in New York, the evidences of ownership were kept in New York, and the trust "administration" took place in New York. The "connection" with Rhode Island, the taxing state, was that one of the

trustees resided in Rhode Island. Although the case dealt with a property tax rather than an income tax, it is at once apparent from the following quotation that the same "benefits and protection" of the appellant and the accumulated income are present in this case. It is stated by this Court at page 495:

> "The Supreme Court of Rhode Island considered the argument that the laws of the state afforded no benefit or protection to the residing trustee. Although nothing appeared as to any specific benefit or protection which the trustee had actually received, it concluded that the state was 'ready, willing and capable' of furnishing either 'if requested.' A resident trustee of a foreign trust would be entitled to the same advantages from Rhode Island laws as would any natural person there resident. *Greenough v. Tax Assessors, supra*, 488, 47 A.2d at 631. There may be matters of trust administration which can be litigated only in the courts of the state that is the seat of the trust. For example, in the case of a testamentary trust, the appointment of trustees, settlement, termination and distribution under the provisions of the trust are to be carried out; normally, in the courts of decedent's domicile. . . . But when testamentary trustees reside outside of the jurisdiction of the courts of the state of the seat of the trust, third parties dealing with the trustee on trust matters or beneficiaries may need to proceed directly against the trustee as an individual for matters arising out of his relation to the trust. Or the resident trustee may need the benefit of the Rhode Island law to enforce trust claims against a Rhode Island resident. . . ."

The Supreme Court determined that the situs of at least one-half of the trust *res* was in Rhode Island. The benefits that would be afforded the trust provided the due process connection for property taxation.

In the present case one trustee and the beneficiary are residents of California, whereas in *Greenough* only one trustee was a resident of the taxing state. The owners of the equitable and a legal interest in the accumulated income and the trust were in California. Actual distribution of the income was in this State. The appellant as trustee had powers and duties with respect to the accumulated income. Therefore, this is even a stronger case of due process "minimum connection" than the *Greenough* case.

Further support for the California tax laws is found in *Curry v. McCanless*, 307 U.S. 357. In *Curry*, Tennessee was allowed to tax the transfer at death of intangibles held by an Alabama trustee in Alabama where the decedent, a Tennessee resident, retained certain controls over the disposition of the intangible property. The decedent was the settlor of the trust. The resident settlor reserved a power of appointment over certain trust assets which was never exercised. This was a potential source of wealth held in Tennessee which could be taxed. It is stated at page 366:

> ". . . Obviously, as sources of actual or potential wealth—which is an appropriate measure of any tax imposed on ownership or its exercise—they cannot be disassociated from the persons from whose relationships they are derived. These are not in any sense fictions. They are indisputable realities."

and at page 370:

> ". . . The decedent's power to dispose of the intangibles was a potential source of wealth which was property in her hands from which she was under the highest obligation, in common with her fellow citizens of Tennessee, to contribute to the support of the government whose protection she enjoyed. . . ."

Appellant, as the beneficiary, received actual distribution of all the accumulated income in 1951, and this is far greater

than any potential power the decedent had in the *Curry* case. During accumulation, appellant, together with his co-trustees over whom he had effective and practical control, also had power to pay, control or allocate more distributions of the income for himself as beneficiary.

In addition, this Court has held that the residency of a beneficiary affords the "minimum connection" to impose a property tax on the beneficiary's equitable interest even though the property is physically in another state. (*Stewart v. Pennsylvania*, 312 U.S. 649). Furthermore, an income tax on income under the control of the resident beneficiary, though undistributed, may be taxed by the resident state. (*Guaranty Trust v. Virginia*, 305 U.S. 19.)

Appellant argues that his uncertainty of receiving the accumulated income should prevent California from imposing the tax. The technical nature of the future interest of a beneficiary is not the controlling factor for purposes of taxation. The important fact is that the equitable interest was held by an identifiable person who was a resident of California (Section 18101). As stated by the California Supreme Court,

> "California thus became entitled to claim reciprocal obligations for 'protection which it has afforded . . .' and 'benefits which it has conferred by the fact of being an orderly, civilized society. . . .' The simple but controlling question is whether the state has given anything for which it can ask return . . . The fact that a tax is contingent upon events brought to pass without a state does not destroy the nexus between such a tax and transactions within a state for which the tax is an exaction.' (*Wisconsin v. J. C. Penney Co.* (1940) 311 U.S. 435, 444-445 [61 S. Ct. 246, 85 L. Ed. 267, 270-271, 130 A.L.R. 1229, 1233].)"

The fact that this state stands ready and willing to grant benefits and protection provides the nexus. (*State Tax Commission v. Aldrich*, 316 U.S. 174; 180; *Blackstone v. Miller*, 188 U.S. 189, 205.) California's possibility, readiness or willingness to benefit or to protect the beneficiary in his relationship to the trust and the income provided the "minimum connection" for taxation under the due process clause.

B. THE CALIFORNIA SCHEME FOR TAXATION OF TRUSTS IS FAIR AND REASONABLE. THE SCHEME IS DESIGNED TO PREVENT ACCUMULATION OF INCOME OUTSIDE THE STATE OF CALIFORNIA FOR TAX-FREE DISTRIBUTION.

Due process is satisfied if the statutory scheme which imposes taxation is fair and reasonable and in line with practical operation. (*Wisconsin v. J. C. Penney Company*, 311 U.S. 435.) The California system for taxation of trusts is designed to prevent accumulation of income outside the state for tax-free distribution to beneficiaries who are residents of this state. (See Traynor, *State Taxation of Trust Income*, 22 Iowa L. Rev. 268, 271.) As the California Supreme Court noted, "The transferee tax thus levied assures this State that resident beneficiaries of the trust administered elsewhere obtain no special advantage over California taxpayers." (*McCulloch* case, 61 C.2d ..... ; 390 P.2d at 420). A California resident whose wealth accumulates under the administration of an out-of-state trustee should not contribute less to the support of this state than would his fellow citizen whose wealth is managed by a local trustee.

The California scheme provides for no additional penalties or interest for the failure of the trust to pay the tax. There is no double taxation because California law provides for full credit for any income taxes paid by the trustee to Missouri. The California tax on appellant is no greater than that which any other beneficiary of a local trust would pay.

The ultimate liability of taxation is borne by the beneficiary who has the equitable interest in the income, whether accumulated or distributed. (*Anderson v. Wilson*, 289 U.S. 20, 27 (1933).) Adoption of the appellant's argument would unnecessarily lead to discrimination in favor of beneficiaries of out-of-state trusts.

C. THE CALIFORNIA SUPREME COURT DID NOT CREATE A "THROWBACK." THERE IS NO VIOLATION OF DUE PROCESS OR EQUAL PROTECTION.

The appellant claims that the California Supreme Court applied a "throwback" which was enacted after the period here involved. (Appellant's Jurisdiction Statement, p. 21) The California Court made no reference, nor in any way depended upon such a "throwback" provision. The court's decision set forth the meaning of section 18106. Section 18106 "imposes upon the beneficiary the *tax liability* which attaches to 'such income,'" which is taxable to the trust. The California Court states:

> "the statute indicates only that if trust income taxes remain unpaid, these taxes are to be met by the beneficiary when the assets are distributed to him." (*McCulloch* case, 390 P.2d at 417.)

The California Court declared that the Legislature, by this section, did not intend to treat the whole accumulation as income in the year of distribution, but only "such income", tax liability that was due from the trust, *is now due* from the beneficiary upon his receipt.

The Court reaches a reasonable interpretation which reduces the heavier tax burden of taxing the entire distribution in the year of receipt of the beneficiary. The Franchise Tax Board had argued throughout this extended litigation that the California Legislature could have, in section 18106,

treated the total distribution as taxable in the year of receipt without violation of due process. In the same way, all the capital gains from sale of an appreciated asset could be taxed at one time in the year the gains are realized or received. There is no constitutional objection to such enactment.

A fortiori there is no constitutional objection to the statutory interpretation which limits such lump sum taxation. Appellant claims that the construction of the California Court violates the equal protection clause since "it subjects an out-of-state trust to a throwback rule . . . without subjecting local trusts thereto . . . ." (Jurisdictional Statement, page 22.) It claims discrimination. The facts refute this. Local trusts would have been required to pay the taxes as the income was earned from sources within the state. The taxes should have and would have been paid each year as earned by the local trust. In this case the trust or the appellant is required to pay an equal amount of tax. No greater burden is placed upon him or the trust than that placed upon local trusts or local beneficiaries. The throwback rule (found in sections 17771-17777, 1964 Personal Income Tax Law, and Internal Revenue Service Code sections 665-668) was enacted as a loophole closing measure. (See Sen. Rep. No. 1622, 83rd Cong., 2nd Sess., p. 85.) The loophole closed was that of shifting income taxes from a high tax bracket beneficiary to lower tax bracket trusts. The operation of the throwback rule prevents this shifting. The beneficiary pays the tax according to the amount he would have paid if the income had been distributed on each of the preceding years.

Whatever similarity there may be between the California Supreme Court's construction of 18106 and these "throwback rules" it is clear the California Supreme Court was not

analogyzing to these rules but was merely interpreting section 18106. In construing section 18106 there was no issue before the court involving the shifting of tax between the beneficiary and the trust. Rather, the issue was how much tax is due from a beneficiary where the trust had paid no tax. Appellant's attempt to characterize the court's holding as a judicially created throwback rule is without merit.

CONCLUSION

Inasmuch as appellant's contentions have been foreclosed by prior decision of this Court, we respectfully submit that this appeal should be dismissed, or in the alternative that the judgment of the Supreme Court of California should be affirmed.

Dated: September 30, 1964.

Respectfully submitted,

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(Appendix Follows)

Appendix A

California Statutes
(Revenue and Taxation Code of 1951)

Section 18101:

"The taxes imposed by this part upon individuals apply to the income of estates or of any kind of property held in trust (other than so-called Massachusetts trusts), including:

"(a) Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests, and income accumulated or held for future distribution under the terms of the will or trust.

"(b) Income which is to be distributed currently by the fiduciary to the beneficiaries, and income collected by a guardian of an infant which is to be held or distributed as the court may direct.

"(c) Income received by estates of deceased persons during the period of administration or settlement of the estate.

"(d) Income which, in the discretion of the fiduciary, may be either distributed to the beneficiaries or accumulated."

Section 18102:

"Except as otherwise provided in Articles 2 and 4 of this chapter, the income of an estate or trust is taxable to the estate or trust. The tax applies to the entire net income of an estate, if the decedent was a resident, regardless of the residence of the fiduciary or beneficiary, and to the entire net income of a trust, if the fiduciary or beneficiary is a resident, regardless of the residence of the settlor."

Section 18103:

"Where the taxability of income under this chapter depends on the residence of the fiduciary and there are two

or more fiduciaries for the trust, the income taxable under Section 18102 shall be apportioned according to the number of fiduciaries resident in this State pursuant to rules and regulations prescribed by the Franchise Tax Board."

Section 18104:

"Where the taxability of income under this chapter depends on the residence of the beneficiary and there are two or more beneficiaries of the trust, the income taxable under Section 18102 shall be apportioned according to the number and interest of beneficiaries resident in this State pursuant to rules and regulations prescribed by the Franchise Tax Board."

Section 18105:

"Taxes on income of an estate or trust which is taxable to the estate or trust are a charge upon the estate or trust and shall be paid by the fiduciary."

Section 18106:

"If, for any reason, the taxes imposed on income of a trust which is taxable to the trust because the fiduciary or beneficiary is a resident of this State are not paid when due and remain unpaid when such income is distributable to the beneficiaries, or in case the income is distributable to the beneficiaries before the taxes are due, if the taxes are not paid when due, such income shall be taxable to the beneficiaries when distributable to them except that in the case of nonresident beneficiaries such income shall be taxable only to the extent it is derived from sources within this State."

TABLE OF AUTHORITIES CITED

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IN THE

Supreme Court of the United States

Docket No. 472
October Term, 1964

ROBERT P. McCULLOCH,

Plaintiff and Appellant,

vs.

CALIFORNIA FRANCHISE TAX BOARD,

Defendant and Appellee.

APPELLANT'S REPLY TO APPELLEE'S MOTION TO DISMISS.

The sole issue raised by the Motion to Dismiss filed by the California Franchise Tax Board (hereinafter called "Appellee") is that "there is no substantial federal question presented" because the issues here "have been foreclosed by previous decisions of this Court." (Motion to Dismiss, p. 1.)

Appellant suggests that the federal questions here *are* substantial:

1. The issues involved in this case have never been decided before. (See Jurisdictional Statement, pp. 14-15; this point is conceded by Appellee, see Motion to Dismiss, p. 5.)

2. The issues involved in this case are important because of the increasing incidence of out-of-state trusts and the increased use of accumula-

tions trusts. (Jurisdictional Statement, pp. 15-16; no comment in Motion to Dismiss.)

3. No case in this Court has ever extended the constitutional concept of *nexus* so far as it was extended in this case. (Jurisdictional Statement, pp. 16-20.)

4. In two respects at least the Court below disregards statutory limitations imposed upon taxation by local law. (See Jurisdictional Statement, pp. 20-21 (100% tax based on residence of one-third of trustees), and pp. 21-22 (judicially-imposed "throwback" four years before enactment of same).

Nexus-preliminary. Since everyone agrees that the tax liability here imposed was a transferee liability—

Appellant (see Jurisdictional Statement, p. 9);
Appellee (see Motion to Dismiss, p. 3);
Court below (see Jurisdictional Statement, App. A, p. 8, lines 24-26, and p. 14, lines 14-17),

then the only tax under attack here is the initial tax on the *trust* for income it received. This is the tax which, in the words of the Appellee, "the trustee should have paid on behalf of the trust as that income was earned." (Motion to Dismiss, p. 3.)

The constitutional issue is whether, "as that income was earned" in 1946-1950, sufficient connection then existed between California's tax on the trust and "transactions within [California] for which the tax is an exaction." *Wisconsin v. J. C. Penney Co.*, 311 U. S. 435, 445 (1940). But in our case the assertedly taxable transaction, the receipt of income each year from 1946 to 1950, was not a transaction which took place in California.

Appellee says *no* transactions are necessary—that "appellant's residency in California in his capacity as the contingent beneficiary and as one of the three trustees" is sufficient to justify the tax on the trust (Motion to Dismiss, p. 4, lines 21-30).

Nexus-residence of prospective distributees. Appellee refers to California's "benefits and protection" accorded the non-recipient contingent beneficiaries and to the "many 'connections' with the accumulated income and the trust." (Motion to Dismiss, p. 6.) But the decisions of this Court, even those relied upon by Appellee, require a protection more relevant to the taxable transaction in question than that enumerated by the Appellee or by the decision below. *Maguire v. Trefry*, 253 U. S., 12, 14 (1920) and *Lawrence v. Tax Commission*, 286 U. S. 276, 281 (1932) required protection afforded "the recipient of the income"; and *Guaranty Trust Co. v. Virginia*, 305 U. S. 19, 23 (1938) taxed "receipt of income within Virginia".

These cases do not justify imposing a tax on a *trust* for out-of-state income because of the residence of a *beneficiary* who does not receive the income "as earned."[1]

Appellee's rejoinder is that California accorded the prospective beneficiaries (Appellant and his heirs) "the interim protection of its laws"—kept them alive and "extended the shelter of its governmental institutions" while Appellant was awaiting age 40 or while his heirs

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[1]It is immaterial how the technical future interest of Appellant during 1946-1950 was characterized—"contingent," "vested" or otherwise. In this we agree with Appellee (Motion to Dismiss, p. 11). The point is that during those years it was the *trust* which received the "income as earned"; Appellant did not receive it then, and he was only a prospective distributee in the future.

awaited his earlier demise. (Motion to Dismiss, p. 6, lines 17 *et seq.* quoting opinion below, Appendix A of Jurisdictional Statement, p. 12.)

No case has ever held that keeping prospective distributees alive is a sufficient connection with the taxable transaction—receipt of income by the trust—to justify a tax on the trust income "as earned". No case has ever held that the court protection afforded a *non*-recipient of income justifies a tax on that income against the *recipient*—even where, as here, the relationship between recipient and non-recipient is as close as that of a trust and its prospective beneficiaries. Compare *West Publishing Co. v. McColgan*, 27 Cal. 2d 705, 713 (*aff'd.* 328 U. S. 823), cited by Appellee (Motion to Dismiss, p. 8), where the court protection *was* afforded the recipient of the income taxed, with *Miller Bros. v. Maryland*, 347 U. S. 340, 347 (1954), striking down a state's attempt to shift to a foreign vendor the tax it could not successfully enforce against its own residents, who bought from the vendor.

> "* * * That these inhabitants incurred a liability for the use tax, that they used, stored, or consumed the goods in Maryland, no one doubts. But the burden of collecting or paying their tax cannot be shifted to a foreign merchant in the absence of some jurisdictional basis not present here." 347 U. S. at 347.

Nexus-residence of one-third of trustees: This, suggests Appellee, supplies any deficiency in constitutional relationship (Motion to Dismiss, p. 10), on the theory that Appellant, as trustee, could enforce the trust's rights in California. Conceding this *arguendo* (we disagree with much of what is said in this context

by Appellee), yet the residence of only one of three trustees by specific statute (see Jurisdictional Statement, p. 20) at most entitles California to tax one-third of the income—not all of it.

Control. Appellee frequently suggests (Motion to Dismiss, p. 7, lines 19-24, and p. 11, lines 2-5) that the sibling relationship of Appellant with one of two co-trustees gave him "effective control" over the trust. (This was not a ground of the decision below, despite Appellee's similar argument.) Had the control been as strong as Appellee's counsel implies, it would have permitted Appellee to attribute the subject income to Appellant in the years earned—even though accumulated into trust corpus—and to assert a direct income tax liability against Appellant, not a transferee liability. *Cf. Mallinckrodt v. Commissioner*, 146 F. 2d 1 (8th Cir., 1945), *cert. denied* 324 U. S. 871.

Summary.

Appellant says that the residence of non-recipient prospective beneficiaries in 1946-1950 is not enough to permit California to tax income received and accumulated by the trust in Missouri in those years. Appellant says that the residence of a single trustee (of three) is not enough to support total taxation of income accumulated by the out-of-state trust, especially where California law, if valid at all, only permits imposition of a tax on one-third of that income in such circumstances.

Appellant respectfully suggests that the questions involved are sufficiently substantial to warrant consideration of this appeal by this Court.

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IN THE

Supreme Court of the United States

No. 472
October Term, 1964

ROBERT P. McCULLOCH,
Plaintiff and Appellant,
vs.
CALIFORNIA FRANCHISE TAX BOARD,
Defendant and Appellee.

Petition for Rehearing of Order Granting Motion to Dismiss Appeal Under Rule 58(1).

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IN THE

Supreme Court of the United States

No. 472
October Term, 1964

ROBERT P. MCCULLOCH,

Plaintiff and Appellant,

vs.

CALIFORNIA FRANCHISE TAX BOARD,

Defendant and Appellee.

Petition for Rehearing of Order Granting Motion to Dismiss Appeal Under Rule 58(1).

Appellant Robert P. McCulloch respectfully requests that this Court grant rehearing of its order dated November 23, 1964, which dismissed the appeal for lack of a substantial federal question, and further requests that on rehearing the Court now note probable jurisdiction and entertain this appeal. This petition is filed under Rule 58(1) of the Rules of this Court.

The appellee Franchise Tax Board's Motion to Dismiss or Affirm stated the question presented herein was whether the beneficiary's residence was sufficient nexus to tax income to the trust:

> "Does the appellant's residency in California in his capacity as the contingent beneficiary and as one of three trustees, provide sufficient nexus to income accumulated by an out-of-state trust so as to allow California to [tax that income to the trust]?"

The Franchise Tax Board contended "that there was sufficient nexus by reason of the appellant's residency" (Motion to Dismiss or Affirm, p. 4). That this was the essential question seems clear from statements in the opinions below.[1]

The Appellant's Jurisdictional Statement did argue the importance of this question and of other collateral questions of constitutional law raised by that decision. Appellant did not, however, indicate that there existed any conflict of decisions between the California decision and the decisions of other states, or that other cases were awaiting decision in this matter pending the outcome of this case.

Appellant suggests to this Court authorities indicating two additional reasons why the federal questions here involved are indeed substantial:

1. The decision in *McCulloch* conflicts with recent decisions in other jurisdictions.
2. The questions involved are more important than the number of appellate decisions indicates because appellate litigation is improbable. But substantial inferior court litigation *is* probable.

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[1] "* * *the beneficiary's state of residence may properly tax the *trust* on income which is payable in the future to the beneficiary, although it is actually retained by the trust * * *." (Jurisdictional Statement App. A, p. 11 (Calif. Sup. Ct. Opinion));

"* * *taxation * * * could not be predicated solely on the residence of the plaintiff in California * * *. See *Miller Bros. Co. v. Maryland*, 341 U. S. 340, 344-345 * * *." (*Idem*, App. A, pp. 23-24, Opinion, Calif. Dist. Ct. Appls.];

"* * * we face squarely the constitutional question of whether income accumulated by this trust may be taxed by California upon the ground that the beneficiary is a California resident. * * *" (*Idem* at App. A, p. 27, dissent.)

I.

The Decision in McCulloch Conflicts With Recent Decisions in Other Jurisdictions.

The California Supreme Court held that income received and accumulated in the years 1936-1950 was taxable *to the trust* as of those years because of the residence of the *beneficiary*, even though the beneficiary did not actually receive the sums until principal (including these accumulations was distributed to him when he survived to age 40 in 1951. The Court so held despite the fact that all of the administrative business of the trust was, by express terms, transacted in another state.

Other cases involving the taxation of accumulations to foreign trusts have reached conflicting results.

> Compare *Pabst v. Dept. of Taxation*, 19 Wis. 2d 313, 120 N. W. 2d 77 (1963),
>
> with *Mercantile-Safe Deposit and Trust Company v. Murphy*, 19 App. Div. 2d 765, 242 N. Y. Supp. 2d 26 (1963).

In *Pabst*, the Wisconsin Supreme Court held constitutional (against attack under the Fourteenth Amendment) Wisconsin's taxation of capital gains accumulated into principal by non-resident trustees for a non-resident beneficiary.

The *Mercantile-Safe Deposit* case held *unconstitutional* New York's attempt to levy income tax upon accumulations made by a non-resident trustee of an *inter vivos* trust created by a New York resident for a non-resident beneficiary.

Mercantile-Safe Deposit cited in support *Safe Deposit and Trust Co. v. Virginia*, 280 U. S. 83 (1929). It appears to be in direct conflict with the opinion of the California Supreme Court in *McCulloch*.

Pabst, holding its statute constitutional, cited in support thereof *Wisconsin v. J. C. Penney Co.*, 311 U. S. 435, 445 (1940). While agreeing with *McCulloch* on the issue of constitutionality, the *Wisconsin* case takes an inconsistent position with *McCulloch* in that in Wisconsin actual management in the state is held to provide *nexus;* in California, actual management elsewhere does not destroy *nexus*.

Counsel for appellant have been contacted by at least six other firms representing taxpayers whose deficiencies are being held in abeyance pending the outcome of this litigation and is informed by them that the Franchise Tax Board is holding in abeyance numerous other cases pending the outcome of this suit. Counsel is aware of two other decisions which ended in the California Superior Courts—both contrary to the *McCulloch* ruling. In one (*Long v. Franchise Tax Board*, Sacramento County Super. Ct. No. 118208), the State took no appeal, and in the other (*Dollar Savings & Trust Co. v. Franchise Tax Board*, Sacramento County Super. Ct. No. 120471), an appeal by the State was settled in preference to litigation.

All these patterns indicate that litigation does arise on the taxation of accumulations in multi-state trusts, but that has the litigation does not travel far through the courts.[2]

We suggest these cases show that the question here is not a question peculiar to California alone, or novel only

[2]The subject was of sufficient importance to become the topic of a paper soon to be published—Ferrell, *State Taxation of Income Accumulated in Trusts*—at the Annual Conference of the National Association of Tax Administrators in New Orleans in June, 1964.

because of the special facts of this case, but that the issues posed by the *McCulloch* decision arise wherever income tax statutes are applied to multi-state trusts, all over the country, and that the cases are in conflict.

II.

The Questions Involved Arise With Greater Frequency Than Appellate Decisions Indicate Because Appellate Litigation Is Improbable.

There are individual income tax statutes in 34 states.[3] Many of these, like California, seek to tax income accumulated and later distributed, such as is involved here, some using language strikingly similar to the California statute.[4] Many likewise seek to tax income of non-residents as well as that of residents.[5] Two states—Michigan and Ohio, respectively the seventh and fifth most populous states in the nation—have enacted a uniform municipal income tax ordinance which permits municipalities to levy an income tax. Under these laws over 60 Ohio municipalities have enacted income tax laws—all with a limitation on rates of one percent—and the population centers of Detroit and Hamtramck have enacted municipal ordinances.[6]

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[3]Penniman and Walter Heller, *State Income Tax Administration* (ed. 1959) 7-8 (30 states) plus the following four added since 1959: Alaska (Alaska Stats. Sec. 43.20.010); Hawaii (Haw. Rev. Laws (1963 Supp.) Secs. 121-3, 121-13); Tennessee (12 Tenn. Code Ann. (Bobbs-Merrill 1955) Sec. 67-2616 and -2617); and West Virginia (W. Va. Code Ann. (Michie 1961) Sec. 999 (50aaa) and (50bbbb)).

[4]See, *e.g.*, Mo. Stats. Ann. (Vernon 1952) Sec. 143.130.

[5]See, *e.g.*, West. Va. Code Ann. (Michie 1961) Sec. 999 (50 aaaa) and (50bbbb) (taxation of non-resident estates or trusts); Haw. Rev. Laws (1963 Supp.) Secs. 121-3; 121-13 (taxation of "every" estate or trust);

[6]See *United States Advisory Commission On Inter-Governmental Relations, State Constitutional and Statutory Restrictions On Local Taxing Procedures* (1962) 88.

All of these statutes have one common denominator: The upper limit of taxation is low—ranging from 10% down to 1%. Consequently, the deficiencies assessed are small when the state seeks to apply the statutes to foreign trusts, and the amounts involved seldom support constitutional litigation involving substantial expenditure of time, effort and money.

In such circumstances it is improbable that litigation will occur in such form as to be recorded in appellate decisions, even though the decisions may be in conflict.

> *Cf. Schriber-Schroth v. Cleveland Trust Co.*, 305 U. S. 47, 50 (1938) where certiorari was granted on rehearing after earlier denial of a petition for certiorari by this Court, when the petition for rehearing disclosed that litigation in different circuits was improbable;
>
> See *Paramount Publix Corp. v. American Tri-Ergon Corp.*, 293 U. S. 528 (1934).

In the present circumstance we suggest that appellate litigation is improbable — and visible conflict therefore doubtful — because of the small size of individual cases. But the collective amounts of money will be large—and the rights of taxpayers will be just as much infringed. We do not think that this Court will fail to recognize the substantiality of a federal question, if otherwise substantial, merely because the amounts involved in each case are small, or that appellate litigation is unlikely.

Indeed, this fact seems more an inducement to recognize the substantiality of the question than a deterrent. It indicates that many cases involving similar questions are arising that are not being litigated to the appellate

court. If this Court does not now accept jurisdiction in the current case, it is unlikely that it will have the opportunity soon again to litigate a question which — every one agrees — has never yet been decided (see Jurisdictional Statement, page 14) and which is even now being decided inconsistently.

The small number of reported cases belies the frequency with which the issue arises; but such decisions as exist make it clear that further guidance of this Court is needed.

Conclusion.

It has been suggested that this Court sometimes shows its approval of a decision on the merits by such an order as it handed down on November 23, 1964, in this case. See Stern and Gressman, *Supreme Court Practice* (3d ed. 1962), pp. 195-196. Obviously, counsel for the taxpayer consider the case to have been wrongly decided. But whether right or wrong, we believe the case is of sufficient importance — and the varying interpretations of the constitutional law on the subject sufficiently in conflict—to merit full consideration by this Court. We believe this is especially true where it is unlikely that the Court will soon have the opportunity again to decide the question.

Respectfully submitted.

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